AN ANALYSIS OF THE
LAW AND PRACTICE OF SECURITISATION

CALVIN REIS ROY

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CALVIN REIS ROY LL.B., LL.M.
OF GRAY'S INN, BARRISTER, LONDON

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THE THANK YOU PAGE

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Calvin R. Roy

SUMMARY OF RESEARCH:

The introduction, and evolution of securitisation over the years, has made a phenomenal contribution to the area of corporate finance. Securitisation is a specialised area which has evolved to deliver considerable advantages to banks and their corporate and government clients, a sub-subjected explored in this thesis. Securitisation is defined as using the cashflow, creditworthiness and collateral of receivables to raise finance from the capital markets. To date, research on the subject of securitisation has produced a few textbooks and numerous articles written by academics and practitioners. The ambit of these writings addresses three questions, namely, what is securitisation; how does it work in practice; and how can securitisation be developed so that it can continue delivering advantages in the evolving world of corporate finance.

Securitisation is very much a practical subject, and given that the author had very little, if any, practical exposure to the subject prior to developing this thesis, the author, admittedly, felt challenged to ascertain significant issues that could be developed to the extent that such development represents an original contribution to knowledge. Case law in the US had already explored the most significant issue regarding securitisation, namely, true sale. Armed with a solid theoretical base of knowledge that author looked for inspiration, and discovered it during the initial days when the Enron scandal hit the headlines.

In short, the Enron scandal involved using the concept of securitisation to facilitate financial crime. The masterminds (if its appropriate to use such description) of the scandal, as this thesis will unfold later, cleverly used thousands of securitisation and hedging transactions to raise funds in order to give financial creditability to a giant corporation which on the surface appeared prosperous but, in reality, was breathing to a large extent on borrowed funds. This scandal, in which securitisation was used, inspired the author to develop the originality of the thesis by focusing on the issue of securitisation and financial crime. Given that financial crime is a huge area to explore, the author narrowed the focus to look at money laundering, and address the question:

Can the practice of securitisation facilitate money laundering?

To approach this question and answer it at doctorate level required a solid understanding of what securitisation is and how it works in practice. Using textbooks, articles and conversations with practitioners, the thesis documents under

Part 1, what securitisation is and how it works in practice before moving on to Part 2 to look at if and how securitisation can facilitate money laundering.

Part 1

Chapter 1 examines the definition of securitisation. It assesses some current definitions before the author provides a justifiable alternative, aimed at clarifying the definition of securitisation. Further, the author has analysed and described in detail the true nature of securitisation so that it can be better and easily understood.

Chapters 2 and 3 examine the crucial role of the credit rating agency instructed by the banker to analyse the pool of receivables using a credit rating analysis. A credit rating analysis tests the receivables against three kinds of risks – credit risk, structural risk and legal risk. This chapter, based on both published and confidential material and detailed discussions with rating agencies, examines in detail the credit, structural and legal risks involved and why these risks can be detrimental. An understanding of credit rating analysis, as the author discovered, assisted in determining the shortfalls of such analysis, and in researching to answer the question posed in this thesis since, as the author discovered, the shortfalls in the credit rating analysis contribute to demonstrate that securitisation can facilitate money laundering.

Chapter 4 examines the legal issues that affect the originator, and secondly, the SPV. Securitisation is used either to remove the receivables from the originator's balance sheet or used to raise favourably rated finance. In the former, the transfer must be structured as a *true sale* so that the legal or equitable title to the receivables is assigned to the SPV, thus, allowing the originator to remove the receivables from its balance sheet. In the latter, the originator is not concerned about removing the receivables from its balance sheet and therefore, just pledges the receivables to the SPV, which in turn uses them to support the bond issue.

True sale is achievable by correctly documenting it in the transfer agreement and complying with the law of the jurisdiction in which the receivables and the originator are situated. In the US, case law has shown that courts are not easily convinced by an agreement that documents a true sale and may rule that the transfer is nothing more than a secured lending. For the first time this case law is examined comparatively with the UK position regarding true sale and ends with original suggestions as to how securitisation can be better understood.

Chapter 5 discusses the legal issues faced by the SPV – e.g. bankruptcy remoteness, correct formation and legal and regulatory hurdles when issuing securities. These complex issues are examined and documented so they can be better understood.

Part 2

Chapter 6 provides an innovative analysis focusing on if, and how, securitisation can facilitate money laundering. As stated earlier, the inspiration behind this research was sparked by the fraudulent activities committed by certain executives at the energy giant that once existed as Enron. The Enron scandal as it unfolded and was reported, uncovered what is now a known fact, that securitisation can be used and abused to commit fraud, a fraud which will be discussed later in this chapter. Although the wrongful activities behind the Enron scandal only demonstrate that securitisation can be used and abused to raise funds in a fraudulent manner, such disclosure inspires one to think whether securitisation can be used and abused to commit other forms of financial crime.

To narrow the inquiry to the extent that it can be practically tested, one needs to formalise a workable hypothesis that connects the activities behind the Enron scandal, securitisation, and money laundering. Thus, the question, *is it possible for securitisation to be used and abused so as to facilitate money laundering*, then becomes, as a working hypothesis: *if the activities behind the Enron scandal are related to the vulnerabilities of a securitisation transaction, then such vulnerabilities may be exploited to the extent that a securitisation transaction may facilitate money laundering.* The author provides an affirmative answer before demonstrating the affirmative answer in both a theoretical and empirical context.

Chapter 7 further develops the original discussion on money laundering and securitisation with an *off-the-wall*, yet innovative look at traditional theories on white collar crime, and asking two questions:

i. *What are the reasons for those involved to take advantage of the vulnerability demonstrated in chapter 4 and commit a white collar crime?*

ii. *Who is likely to engage in white collar crime?*

The work ends with a chapter summarising the research findings.

LITERATURE REVIEW

Securitisation is one of those areas which does not have many publications that can assist an inquiring mind. The leading textbooks are both written by US authors, Jason Kravitt and Steven Schwarcz, which provide a good understanding of securitisation and how it works in practice. Kravitt (1996) provides a very much practical viewpoint of the subject given that he is well respected practitioner in the area of securitisation, whereas, Schwarcz (1993) provides a good academic slant to the subject. Vinod Kothari (1999), a practitioner and an academic, provides an examination of securitisation that is largely based on the works of Kravitt and Schwarcz. In order to understand securitisation and gain the ability to write chapters 1, 4 and 5 the author relied heavily on these texts (and any articles referenced therein) and the academic articles listed in the reference list. Other useful textbooks were Philip Wood's authoritative book, *The Law and Practice of International Finance*, and Ravi Tennekoon's *Law and Regulation of International Finance*, each of which provided some of the basic information that assisted in understanding the work of Kravitt and Schwarcz. There is nothing original stated in the chapters 1, 4 and 5, except the author analysis of the definitions of securitisation.

Chapter 2, in contrast, provides some originality based on publications released by Standard and Poor's and Moody's Investor Services. Existing work on credit rating, namely, Kravitt (1996), Schwarcz (1993) and Kothari (1999) do, in fact, discuss credit rating but do not provide much detail, and certainly do not demonstrate how credit rating works in practice. Standard and Poor's were more helpful than Moody's, in that, they released much of the materials which were used to write chapter 2.

Chapter 6 is largely based on personal communications with certain professionals either by telephone or email. The confidential research behind chapter 6 could not be found in any textbooks simply because it was an unexplored area of securitisation and money laundering. However, textbooks and articles, as referenced in the chapter, were used as a primary source to provide an understanding of money laundering. Chapter 7 follows on from chapter 6 with an innovative discussion of white collar crime and securitisation was based on textbooks and articles written by academics who discussed traditional theories of white collar crime. The area of white collar crime, admittedly, does have a large number of textbooks and articles supporting it, however, the author intentionally chose to focus on traditional theories and how these relate to securitisation and white collar crime. The textbooks and articles used do not discuss securitisation, nor the angle from which the author approached the discussion in chapter 6.

Instead, they provide a good understanding of white collar crime so that such understanding could be used as part of the discussion in chapter 7. The author's contribution is such that it expands the area of white collar crime with an innovative look how traditional theories of white collar crime relate and help explain why certain individuals would commit white collar crime using securitisation.

Calvin R. Roy

CHAPTER 1 THE NATURE OF SECURITISATION

1. WHAT IS SECURITISATION?

Securitisation is a financing technique which, due to its complexity, is sometimes inaccurately defined by some commentators. At first sight, securitisation can be mistaken for an offshoot of factoring. However, a closer comparison shows a marked difference (chapter 1, pg. 3). Securitisation has been defined, albeit inadequately, in a number of ways. For example, Elmgren (1995: 14) defines it as, 'the process of converting receivables...into securities that...[are]...traded on the capital markets'. Another academic defines it as, 'a financial technique that actually replaces non-tradeable balance sheet assets with freely negotiable bearer securities' (Goris, 1994: 8). Finally, it is rather elaborately defined as, 'a device of structured financing where an entity seeks to pool together its interest in identifiable cash flows over time, transfers the same to investors either with or without the support of further collaterals, and thereby achieves the purpose of financing. Though the end-result of securitisation is financing, but it is not "financing" as such, since the entity securitising its assets is not borrowing money, but selling a stream of cash flows that was otherwise to accrue to it' (Kothari, 1999: 2).

A close analysis of how securitisation works in practice shows the inaccuracy inherent in the cited definitions. Securitisation merely consists of utilising balance sheet assets as security and financial support to raise off-balance sheet finance from the capital markets. It is not exactly 'converting receivables...into securities' as Elmgren puts it because a receivable is an amount of income, a derivative of a contractual relationship between a creditor and debtor, which has an unalterable legal characteristic. It is not possible, theoretically or practically, to change the legal or obligatory characteristic of a receivable into one of a security that is traded on the capital markets.

The second definition is also misrepresenting securitisation. It is true that it is a financing technique but it does not 'actually replace non-tradeable balance sheet assets with freely negotiable…securities.' As just stated, receivables have their own legal identity which derive from a contract. The terms of such contract or the governing law of such contract cannot recharacterise the receivable once it exists. The receivable is intangible property with an unalterable identity created by law. Thus, it cannot be replaced as Goris states in his definition, nor does his definition hold much accuracy within the context it was written.

The definition documented by Kothari is useful to a certain extent but rather confusing when examined. The definition starts by defining what is generally called *non true sale* securitisation or secured lending, that is, transferring receivables to a separate legal entity (structured as a corporation or a trust) which, in practice, is called the "special purpose vehicle" ("**SPV**") under an arrangement whereby the receivables are pledged as security in exchange for a loan from the SPV. Kothari's definition mentions non-true sale securitisation by saying that securitisation is 'a device of structured financing where an entity seeks to pool together its interest in identifiable cash flows over time, transfer the same to investors either with or without the support of further collaterals, and thereby achieve the purpose of financing.' It is true that the originator transfers receivables to the SPV, but what Kothari fails to state in his definition is how and in exchange for what the receivables are transferred.

Kothari goes on to say, 'though the end-result of securitisation is financing, but it is not "financing" as such, since the entity securitising its assets is not borrowing money, but selling a stream of cash flows that was otherwise to accrue to it.' This sentence is rather confusing since in the event that the originator is transferring under a non-true sale securitisation (or secured lending), the originator is in fact borrowing funds from the SPV in exchange for a security interest in the pool of receivables – the end result is financing. Kothari says that the end result is financing but then shifts the focus of his definition on to *true sale* securitisation. He says that the end result is not financing but selling a stream of receivables. It seems that this definition is based on a wavering focus that shifts unjustifiably between *non-true sale* and *true sale* securitisation without placing securitisation in its correct context.

A true sale securitisation is what some commentators say is a *real* securitisation (Kravitt 1996; Lupica 1988; Schwarcz 1993). Their perception has been based largely on the fact that this type of structure is the common structure used since the inception of securitisation. This kind of structure has also been labelled as secondary securitisation and mistakenly, as *structured finance* (Kravitt, 1996: 11; Schwarcz, 1993: 41). The true sale structure puts in to practice the second of the two reasons why the originator would arrange a securitisation – the reason will be examined later in this chapter. However, to aid current discussion, the originator composes a securitisation because it has receivables which it wants to remove from its balance sheet. Under true sale the originator transfers the legal and beneficial rights in the receivables to the SPV.

A definition which reflects securitisation with more accuracy is one which captures the actual technical process of securitisation, such as, securitisation is utilising the historical and predicted performance, the collateral, creditworthiness and cashflow of an entity's assets as security to raise finance from the capital markets. The process of securitisation is carried out by the party which actually utilises the receivables to raise finance. Depending on the structure the party can either be the originator or the SPV (Kravitt, 1996: 18).

If a definition of securitisation focuses exclusively on the actual process of isolating identifiable receivables and then transferring them to another entity, this whole operation also describes factoring. Factoring is a historical arrangement whereby an entity sells book debts (receivables) to another entity in exchange for funds – usually at a lower price than the face value of the debt. How those funds are raised is immaterial in the factoring transaction. Thus, in effect, if a definition of securitisation focuses exclusively on the act of isolating – an entity identifies book debts (receivables) and then sells them to another entity – such definition arguably reflects factoring.

However, what distinguishes securitisation from factoring is that securitisation involves the actual use of those receivables in order to raise funds to purchase the receivables. Securitisation is not merely the act of isolating the receivables (which is factoring) but also includes the method of using such receivables to raise finance in order to purchase the receivables.

Thus, the party which engages in the securitisation is the party which uses the receivables to raise the purchasing finance, and this can be either the originator or the SPV depending on how the securitisation transaction is structured. Where the transaction is structured as a non true sale transaction, the originator pledges, under a loan and security agreement, the receivables as security to the SPV in exchange for a loan, funds which the SPV secures from capital market investors. In practice, the originator will grant a first priority security interest in the receivables to the SPV, which the SPV will register. It is then free to use that security interest and grant a sub-security interest to capital market investors. A sub-security interest can only be granted once the first security holder has registered its security interest (Goode, 1988).

Conversely, where the securitisation is structured as a true sale transaction using a receivables purchase agreement then the SPV is the party securitising the receivables since it is raising finance (and giving a security interest in the receivables to the investors) in order to purchase the ownership in the receivables. The originator cannot utilise the receivables as security to raise finance or grant a security interest because it does not hold title of ownership – an entity can only give a security interest if it holds title of ownership in the underlying asset (Goode, 1988). Thus, if the originator has transferred the receivables under a true sale it no longer holds title of ownership in the receivables and thus, cannot use the receivables as security to raise finance. The bonds which are issued are supported by, *inter alia*, the cashflow of the receivables and such receivables act as security in the event of default. Thus, the party using the receivables to raise finance is the party which truly undertakes the securitisation – the other party acts as the facilitator (Kravitt, 1996: 20).

2. THE PROCESS OF SECURITISATION

There are three distinct types of structures which allow an entity to 'securitise' intangible assets in the form of receivables, namely, non-true sale (or secured lending), true sale and structured finance (Kravitt, 1996: 4-5). Although the structures may be distinct, the actual process of securitisation within each structure remains the same. The process is constructed by three transactions involving three parties:

1. The entity (originator) that wishes to raise finance sells or pledges intangible assets to a legally separate entity called a special purpose vehicle. This vehicle can be a company or a trust.
2. The SPV issues bonds or certificates in the capital markets so that it can raise funds to purchase the intangible assets from the originator or lend funds to the originator (depending on the structure).
3. The SPV pays the originator the purchase price or gives a loan from the proceeds of the bond or certificate issue.

2.1 THE FIRST TRANSACTION

"...The entity...that wishes to raise finance..."

In a securitisation structure the entity seeking to remove receivables off its balance sheet in exchange for funds is called the 'originator' because it originates the receivables. The originator can be either a corporation, trust or a financial institution.

The requirement that triggers the initiation of the securitisation arrangement is that the originator must be a creditor in an existing contractual relationship. The nature of the contract is not as important as the fact that the originator must have fulfilled or has ascertained its obligation under the contract. Where this has not occurred the originator is not in a position to translate the contract as an intangible asset.

From a credit rating perspective contractual rights become assets when the originator has fulfilled its obligation and anticipates the financial benefit to materialise (Standard and Poor's, 1993i). It only becomes an intangible asset once the originator fulfils its obligation and waits for the co-party to fulfil its payment obligation – until the originator has not fulfilled its obligation the receivable is known as a *contingent* receivable (Schwarcz, 1993: 56).

"...sells/pledges assets..."

As mentioned, the intangible asset which the originator generates is the expected payment obligation of the co-party in the contractual relationship. This expected payment obligation is only of value to the originator in the context of securitisation (and from a financial perspective) if it produces reliable cashflow (Schwarcz, 1999). This intangible asset that produces a cashflow is called a *receivable* which, in practice, is an amount of interest and principal (or just principal) paid to a creditor as a payment obligation under a creditor-debtor contractual relationship (Standard and Poor's, 1993v: 61). The receivable may consist only of principal where the underlying obligor does not pay interest as part of the debt. Usually such a receivable would be a trade receivable where the underlying debtor is paying for the cost of the goods or services purchased without incurring or obligated to pay interest (Standard and Poor's 1993k: 11).

Since the inception of securitisation many different types of receivables have been found to be suitable assets for purposes of securitisation. The characteristics that determine suitability according to Standard and Poor's (1993v; 1993r) include:

i. receivable selling or pledging that is not prohibited by contract;
ii. the receivables result from products delivered or services performed;
iii. the receivables generate a predictable cashflow;
iv. the default risk of the receivables can be predictable;
v. the receivables must have a high liquidation value;
vi. the receivables must secure a credit rating that is higher than the rating assigned to the originator;
vii. the security interest in the receivables must be perfectable when sold; and
viii. the receivables must be capable of being pooled together.

Where the originator is a corporation continuing a business for profit, it may be the case that the originator has borrowed money and is subject to an anti-disposal covenant in the loan agreement. Anti-disposal covenants are commonly utilised to ensure that the lender acquires some comfort that the borrower will preserve its assets, which, *inter alia*, are essential to the continuity of the borrower's business (Penn, Shaw and Arora, 1987: 6.48). A lender who has extended a loan or an overdraft will be concerned that the borrower does not reduce its liquid assets to a level which can trigger financial difficulty. When selling or pledging receivables the originator needs to ensure that the sale or pledge of such cashflows will not be deemed by any lender as reducing the liquidity of the company to a threatening level.

The receivables sold must be guaranteed payments so that the SPV does not suffer from non-payment (in practice, called credit risk). To avoid this problem the originator must only sell or pledge receivables from underlying contracts which have been completed from the originator's part. The originator must have delivered the goods to its co-party or performed its required obligation to the satisfaction of its co-party and is in a position to expect payment for such goods or services. The underlying contract must be valid under the law of the jurisdiction in which, either party (if an international agreement) or the parties are established and operate their business.

The originator must sell receivables that are predictable. This predictability must also extend to prepayment. The degree of predictability is essential knowledge for the originator as this will determine the type of security the SPV will need to issue, in that, the payment pattern of the receivables will determine the payment pattern on the securities. The degree of predictability will depend on whether the underlying contract contains within it an amortisation schedule and a final maturity date. An amortisation schedule will set out the payment pattern, i.e. the amount and frequency of the payments from the co-party.

For example, in a contract for a mortgage the payment pattern is indicated for the entire period of the mortgage. The borrower knows the amount and frequency of the repayment. The maturity date is the date on which both parties' obligations expire according to the terms of the mortgage contract. The maturity date of the receivables will determine the maturity date of the security issued. For example, a mortgage obligation with a maturity date of 25 years is ideal to issue long term securities, i.e. 10-15 year bonds (Standard and Poor's, 1993a). However, in contrast, a credit card obligation has no maturity date therefore, the securities can only be short-term so that reinvestment in new receivables can be undertaken (Standard and Poor's, 1993r).

According to Standard and Poor's (1993r: 17) prepayment of loans is a controlled risk because the SPV can reinvest the prepaid principal in new receivables. The only loss is the lost interest which was expected. Historical statistical data held by a credit rating agency can assist in predicting prepayment patterns of individual types of receivables (Standard and Poor's 1993a: 5; Moody's Investor Services, 1996). Prepayment of loans often occurs, in the case of mortgages, when the borrower wishes to sell the property or, in the case of other instalment based loans when the borrower receives a lump sum of money which is used to prepay a loan. The condition of the housing market or a fall in interest rates often influences prepayment (Standard and Poor's, 1993a: 5).

The risk that the borrower may default under the loan can be remedied. For example, in a mortgage contract if a default occurs on part of the borrower the lender is in a position to take charge of the mortgaged property. Further, an insurance policy will absorb any loss sustained should there be a shortfall in the security. Where there is a risk in other types of receivables this is usually remedied by purchasing extra receivables or *overcollateralising* the securities issue so that the economic impact of any default is reduced to its minimum. Overcollateralising in this context means purchasing additional receivables so that the pool supporting the securities issue is fractionally excessive (see chapter 2).

For the receivables to act as security to back a securities issue, the receivables must be of similar type. They must have similar characteristics such as payment patterns. For example, to issue long term securities long term receivables are needed. If the pool of receivables consists of receivables with different payment patterns and maturity dates then this will lead to what is called a mismatching of receipts and payments (Standard and Poor's, 1993m), and further, can pose a major liquidity risk, ultimately resulting in a disastrous loss for the issuer. The originator must have a sufficient amount of similar receivables to support a securities issue. Securitisation is an expensive operation. To make it economical the originator must sell or pledge the right amount of similar receivables to the SPV so that the receivables can support the securities issue. An insufficient amount may lead to an *undercollateralisation* of the securities issue. Undercollateralisation is when the cashflow and security supporting the securities issue is insufficient to absorb default risks and investor payments at the maturity date (see chapter 2). Although credit enhancement facilities may be used to provide liquidity support, an issue that is *overcollateralised* will secure a better credit rating than that which is *undercollateralised* (Standard and Poor's, 1993r).

The originator needs to transfer the receivables to the SPV in a manner structured as a sale at arm's length. This sale of the receivables is contained in a document called the Receivables Purchase Agreement (Kravitt, 1996). This is signed by the originator and the authorised signatories of the SPV. This agreement contains all the contractual terms relating to the sale of the receivables.

If the receivables are pledged as security for a loan from the SPV then the loan and security agreement must give the SPV a first priority interest in the receivables so that they give the support needed. The security interest must be perfected according to law of the jurisdiction in which the receivables are based. The essence of the loan and security agreement or the Receivables Purchase Agreement is to ensure that the receivables once pledged or sold are removed from the originator's other assets so that the receivables are utilised solely for the bond issue (Kravitt, 1996; Schwarcz, 1999).

2.2 THE SECOND TRANSACTION

"...SPV..."

The special purpose vehicle is the receiving entity sponsored by the originator to satisfy the legal, accounting and bankruptcy principles. The law of the jurisdiction in which the originator and the SPV operate should observe the SPV as a separate existing entity.

Securitisation structures utilise either a public or private corporation or a trust as a SPV. In the UK both structures are commonly called securitisation. In the US a structure utilising a trust is called a *pass-through* transaction whereas a structure which facilitates securitisation using a corporation is called a *pay-through* transaction (Kravitt, 1996).

The trust involved will be one whose purpose is to purchase the receivables and pay investors. In this structure the originator transfers receivables to a trust which is specifically established to purchase the receivables and carry out duties essential to the maintenance of the structure. One of the essential duties is to convey acquired payments from the underlying receivables to the investors on a timely basis. Independent trustees are elected to carry out the duties with a trust manager, who has overall control of the trust.

In the US, tax law together with trust law has created three types of trusts, namely, grantor trusts, owner trusts and a master trusts, which are widely used when securitising receivables. In the UK only two types of trusts exist, namely, non-trading trusts and a trading trusts.

A grantor trust is established specifically so as to enable it to acquire a non-taxable status under *U.S. Dept. of Treasury Regulations* – s.301.7701-4. The trust is structured to enable it to acquire a non-taxable status. For it to maintain this status the trust (1) must not engage in a profitable business (2) must not be empowered to vary the terms of the investment, and (3) must only issue ownership interest based on a single class of securities. The first of these requirements means that the trust should not hold itself as a trading trust. Therefore, it cannot be used if reinvestment in new receivables is sought (reinvestment is discussed in chapter 2). Because the trust will secure a non-taxable status, taxation is levied on the investors who pay as though they directly own their pro rata share in the underlying receivables. If the trust fails to maintain the non-taxable status then inevitably it will be taxed as a company or an owner trust. A grantor trust is used when securitising instalment obligations with defined amortisation schedules and fixed final maturity dates, such as mortgages, car loans and other instalment loans. The reason for this is that income from the receivables will flow freely and merely pass-through the grantor trust to the investors. There is no need to reinvest income in new receivables as the securities issued and the receivables will have long maturity dates and further, the securities will certainly expire before the receivables expire, save for an early default of the receivables (Kravitt, 1996: 78-81). The grantor trust is the English equivalent of a non-trading trust. The non-trading trust works in a similar fashion to a grantor trust (Bloomberg, 1997: 54).

An owner trust will not qualify as a non-taxable trust because the appointed trust manager is empowered to deal with the cashflows of the receivables in an instructed and prudent manner. Instead of the income flowing from the receivables to the investors, it is withheld by the trust manager and paid according to the income demands of the investors. An owner trust will issue interests in the trust backed by receivables with different maturity dates and amortisation schedules. Since an owner trust can engage in business activity, it can reinvest principal payments received from the receivables in new receivables so that the investor's interest in the trust remains at the original level – this also viewed as *overcollateralisation* – a form of credit enhancement (Kravitt, 1996: 78-81). The receivables are usually short-term obligations, i.e., credit card receivables, which expire rapidly. As a result the trust manager ensures that the trust's pot of receivables is not exhausted. To do this the trust manager purchases new receivables and thus maintains a stable pot giving the investors a continuing and stable interest in the trust.

A master trust is utilised so as to enable the issuer access to multiple markets simultaneously. The originator transfers the receivables to a master trust which will issue more than one class of ownership certificates.

"...issues bonds or certificates..."

Once the SPV has agreed to purchase or receive the receivables from the originator, it needs to find the necessary finance in order to pay for them. It does this by issuing securities publicly or privately. Typically, the SPV will either issue bonds or certificates.

A trust will fund the acquisition of the receivables by issuing equity-like interest in the trust in the form of trust certificates to investors. These certificates represent an undivided fractional beneficial ownership in the underlying receivables (Standard and Poor's, 1993s).

In a private placement of certificates, participation certificates are offered, giving the investors an interest in the receivables as opposed to in the trust as is the case in a public offering. The important distinction between private and public offerings is that in the former, the investor has a direct link with the receivables due to the interest the investor acquires in the receivables and can enforce rights without an intermediary, whereas in the latter, the investor normally has an indirect link with the receivables as the investor owns an interest in the trust only. This is because the link with the receivables is through an intermediary (normally a trustee) who is utilised by the issuer to handle the physical administration of the issue for reasons of convenience and cost effectiveness. In the event of a default on part of the issuer the trustee will enforce rights on behalf of the investors.

Alternatively, a trust may issue commercial paper – a short-term security (it usually expires within a year) and so is suitable for short-term receivables. Where the SPV is a corporation the acquisition of the receivables will be funded either by a bond issue or a commercial paper issue.

2.3 THE THIRD TRANSACTION

The third transaction entails the SPV paying the proceeds of the bond or certificate issue to the originator either as the purchase price or as a loan. Since the bond/certificate issue may not raise the needed finance, the SPV relies on the underwriting facility provided by the lead manager (the bank instructed to carry out the bond issue) so that all of the finance needed can be paid to the originator.

3. TYPES OF SECURITISATION

Securitisation has been used in three types of distinct structures – distinct in their nature and result. What determines the appropriate structure is the intention of the originator since it holds title of ownership in the receivables at the outset. The three types of structures exist due to the dichotomy of securitisation – either to sell or pledge receivables to raise finance. These three types of structures are generally known as non-true sale, true sale and structured finance (Kravitt, 1996: 4-5; Kothari, 1999: 11).

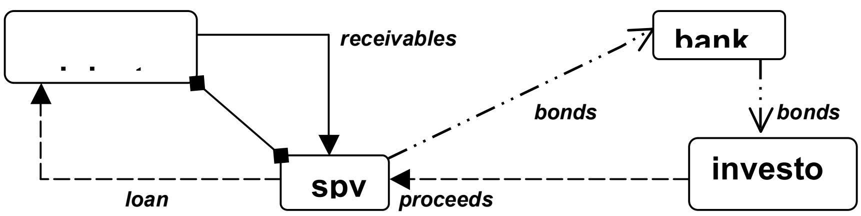
3.1 NON-TRUE SALE SECURITISATION

Here the structure is composed by the originator, with the aid of the investment banker, with the aim of raising favourable rated finance. The originator is the party which owns the receivables and it will have a trading history. Its balance sheet will have both an assets and liability page. Depending on the extent of its existing borrowing, the originator may desire to raise additional finance. The options are either to approach its banker or approach investors in the capital markets. Bank borrowings may require security or the balance sheet may not permit further borrowings against collateral.

The alternative method would be to raise finance from the capital markets through a debt issue. A debt issue will only be permissible if the balance sheet allows it, and therefore the final option may be to use any receivables generated by its business as collateral for further borrowings.

From an accounting perspective the borrowing against the receivables remains on the originator's balance sheet due to the rules of consolidation (Elmgren, 1995: 47). Where the primary aim is to raise favourable rated finance this poses no concern for the originator. The originator's ability to borrow from the capital markets is limited by its corporate credit rating. Any bonds issued by it using its assets as collateral will be successful to the extent of its corporate credit rating. A higher rating (AAA) will secure a favourable rate of finance from the investors – favourable in the sense that the originator repays the principal with interest calculated at a lower rate, thus, making the borrowing a cheaper alternative to bank borrowing.

The securitisation is structured such that the originator isolates a pool of receivables which are pledged to the SPV as security against as loan raised by the SPV from capital market borrowing, for example,



(Source: Elmgren, 1995)

Since the bonds are supported by the receivables, the credit rating agency will analyse only the receivables in order to give a credit rating to the bond issue (see chapter 2). The structure is enhanced with guarantees, and additional receivables which are purchased periodically throughout the life of the bonds using a reinvestment programme. With this support and the reliability and creditworthiness of the receivables, the credit rating agency will typically give the bond issue a high rating – usually AAA (Elmgren, 1995; Standard and Poor's, 1993r). In this way, the originator has secured AAA rated finance using its intangible assets as a favourable alternative to bank borrowing. Further, the finance raised through the SPV will appear in the originator's balance sheet as a lost cost liability (Sargent, 1989; Standard and Poor's, 1993r).

3.2 TRUE SALE SECURITISATION

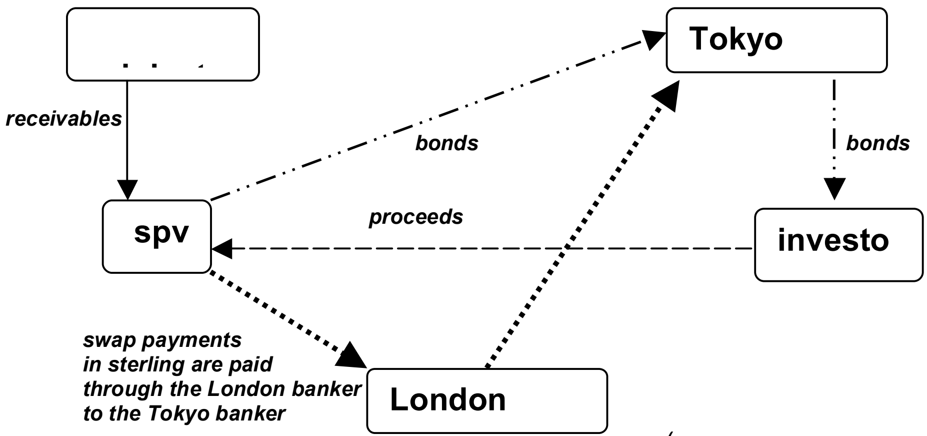
The true sale structure puts in to practice the second of the two reasons why an originator would arrange a securitisation, that is, it desires to remove receivables off its balance sheet. Receivables are intangible assets which derive from contractual obligations with third parties – in the form of payments. An entity in active trade will accumulate several receivables which, although are in fact an asset, also hold an element of risk. This risk is non-payment or default risk – the debtor may not pay the originator.

Under a true sale structure the originator sets up a SPV and transfers, under a receivable purchase agreement, a pool of receivables. The true sale transfer allows the originator to relinquish the legal and equitable ownership in the receivables and pass this to the SPV. The crucial element of the transfer is the operative language used in the Receivables Purchase Agreement. For present purposes, however, the operative language of the transfer is drafted with the effect that the sale takes place between two separate parties at arm's length, whereby the originator sells and assigns all of its rights, title, interest and benefits in and to the transferred receivables.

A spin-off effect of the true sale language is that, given the sale is between two separate parties, the SPV's assets are not merged within the estate of the originator in the event of the originator's bankruptcy and consolidated into the balance sheet of the originator (Sargent, 1989: 65).

3.3 STRUCTURED FINANCE

Structured finance is using securitisation in an ingenious way to achieve a specific result. It differs from non-true sale and true sale structures in that it uses other financial products in addition to securitisation to achieve a specific result. For example, assume that Scooby Do Ltd, a credit card company, wishes to remove receivables off its balance sheet. It holds talks with the banker, who informs Scooby Do Ltd. that a securitisation would be a viable option. The banker further informs Scooby Do Ltd. that the market in London has taken a battering in the aftermath of Enron so any bond issue may not be successful – successful in the sense that not all of the bonds will be sold – but a bond issue in Tokyo would be more successful. The banker contacts its Tokyo office and asks them to issue the bonds to Japanese investors. The bonds are issued and sold and the SPV enters into a currency swap agreement with the Tokyo banker, which will act as the paying agent in Tokyo. Thus, as the receivables are paid in sterling they are converted into yen, by virtue of the swap, and the investors are paid in yen.



(Source: Standard and Poor's, 1993d)

The originator has successfully issued bonds in Tokyo and raised the desired finance by removing the receivables.

The securitisation can utilise either a non-true sale or true sale structure in order to raise the finance. It depends on the balance sheet – whether receivables need to be sold or pledged. However, in order to achieve a specific result (in the above example it was issuing bonds in Tokyo and paying in yen) an additional product is incorporated into the structure. Other common products are interest rate swaps which aid the originator to achieve a desired interest rate result.

3.4 Parties Involved

A typical securitisation involves the following key parties:

1. *Originator*: the entity which originates the receivables. It is the party which initiates the securitisation by either selling or pledging the receivables. The originator works with the banker in composing the structure.

2. *SPV*: the entity which purchases or takes a security interest in the receivables from the originator. The SPV is, typically, a thinly capitalised entity with narrowly defined purposes and activities, and has independent trustees/directors.
3. *Investors*: the investors may be individuals, or institutional investors like, mutual funds, pension funds, and insurance companies.

Aside from these three primary parties, the other parties involved are:

1. *Obligor(s)*: the obligor is the originator's debtor – the underlying debtor with whom the originator has established a contractual relationship which gives rise to the receivable. The amount outstanding from the obligor is the receivable that is transferred to the SPV.
2. *Rating Agency*: since the investors take on the risk of the asset pool rather than the originator, a credit rating agency assesses the strength of the receivables and the mechanism designed to ensure full and timely payment, the extent of credit and liquidity support provided and the strength of the legal framework.
3. *Servicer*: collects the payment due from the obligor, follows up with delinquent obligors and pursues legal remedies available against the defaulting obligors.
4. *Agent and Trustee*: accepts the responsibility for overseeing that all the parties to the securitisation perform in accordance with the securitisation trust agreement - it is appointed to look after the interest of the investors.
5. *Structurer or Banker*: an investment banker, responsible for bringing together the originator, credit enhancers, the investors and other parties.

The entire process is broken up into separate parts with different parties entering into different contracts. When all the contracts and parties are brought together, the whole process facilitates a securitisation.

4. WHY SECURITISE?

Securitisation has prospered for two reasons, namely, it allows an entity to sell intangible assets and remove the associated risk, or to utilise isolated intangible assets as support for raising finance instead of relying on the entity's business operations for support. Underlying the prosperity of securitisation are certain benefits which the securitisation industry and commentators have voiced. For example, Schwarcz (1993: 14-16) and Elmgren (1995: 21-24) highlight the following benefits which they believe securitisation delivers:

1. **Raise favourable rated finance**

Securitisation has been used as a process to raise low cost finance from the capital markets by issuing debt securities. In the absence of this process an entity can still issue debt securities but it will rely on its business reputation and operations as support for the securities. For example, an entity that desires to issues bonds conventionally will approach a credit rating agency for a bond rating. The agency will examine entity's corporate rating and its business operations. The corporate rating is a good indicator as to the entity's ability to repay any debt borrowed from the capital markets. Thus, this would be a factor in the credit rating's determination of the bonds rating. Typically, an entity's bonds are rated very similar to its corporate rating. The reason for this is because the issued bonds are as good as the corporate issuer. If the corporate issuer has a lower rating then invariably its bonds are rated to reflect this.

However, securitisation allows the entity to borrow from the capital markets regardless of its own corporate rating. What makes securitisation unique is that the rating assigned to the bonds issued by the SPV is based primarily on the receivables. The rating agency focuses its analysis on the reliability and strength of the receivables which act as primary support for the bonds issued. The entity originating the receivables is analysed to the extent of its ability to pass on the payments from the receivables to the SPV. Where the receivables are existing rights to payment then the rating agency focuses on the receivables. However, where they come into existence at a future date (future receivables) then the agency analyses the originator's ability to create the receivables. In any event, the rating of the bonds reflects the reliability and strength of the receivables and whether they pose any risk to the investors (Elmgren, 1995: 24).

In this way, the entity can sell or pledge receivables to the SPV in exchange for funds which have been raised with an interest rate that reflects primarily the quality of the receivables. The securitisation structure is composed so that it acquires a high investment grade – AAA – which will pay investors a low rate of interest since there is little, if any, risk affecting the investors. Additional support is incorporated into the structure so that investors do not carry any risk of non-repayment.

Moreover, the majority of investors are laypersons who do not understand the technicalities behind bonds. They want information in a simple form. Thus, when they purchase bonds they look to the rating assigned and the rate of return. The private investors, however, are capable of understanding the technicalities behind the bonds so look to the assigned rating before deciding to look further into the bonds. Therefore, in order to invoke interest in the bonds, the entity would strive to acquire a rating which will aid the success of the bond issue. A higher rating would invoke interest without further enquiry and result in a successful bond issue.

2. Transfers risk

Receivables are intangible assets which appear on an entity's financial statements as earned income or in the case of future receivables, as potential income. The assets aid the entity to continue its business operations and provide liquidity. However, as stated earlier, these intangible assets do carry an element of risk – the risk of non-repayment or default. An entity cannot predict the exact extent of this risk in each fiscal year, and thus, keeps in reserve an amount of money which will absorb some degree of this risk.

For banks, they must adhere to strict rules pertaining to capital adequacy and have in reserve capital which will absorb some degree of risk and loss. For banks and non-bank entities competition and the drive towards prosperity can place the entity in a position where its capital reserve needs to be monitored. This capital reserve ceiling can affect an entity's ability to grow beyond its reserve.

Securitisation allows an entity to transfer the risk inherent in intangible assets and free up capital reserve. The ability to transfer risk occurs in both a *non-true sale* and *true sale* structures. In a true sale transaction the risk is transferred due to the legal assignment inherent in the receivables purchase agreement. In a non-true sale transaction the receivables are isolated, transferred to the SPV and become the 'property' of the SPV when it perfects the security interest (Shenker and Colletta, 1991: 2). This process allows the risk to be transferred because firstly, the receivables have been exchanged for received funds from the SPV, thus, eliminating any risk of non-payment or default for the originator, and secondly, any risk that is transferred to the SPV is covered by credit enhancement – the risk is ultimately transferred to those who provide loss cover who are strong enough to absorb it. Thus, the effect of securitisation is the creation of a link between entities willing to accept the risk of non-payment or default but who subsequently transfer it on.

3. Transforms the receivables into cash

Although the receivables have created a right to payment from the underlying obligor or the potential for payment, the receivables have not produced the payment in tangible form. Securitisation allows an entity to transform an intangible receivable into a tangible receivable. Or in the case where the right to payment does not exist other than the potential to earn that right, securitisation allows the entity to transform this right or potential right into a tangible asset. It provides the liquidity which is expected at a later or unpredictable date. Thus, the effect of securitisation is that it accelerates the evolution of the receivable – from intangible to tangible form.

4. Maintains an active market

Securitisation has developed an active market for asset backed securities. These securities are debt securities that are supported by the receivables. The market developed in the US before growing in other countries around the globe. The continuous development of securitisation allows the market to remain active.

5. Off-balance sheet finance

The ambit of this work does not include a discussion on securitisation from an accounting perspective. However, securitisation is associated with what accountants call "off-balance sheet finance" thus, it is worth a brief mention. "Off balance sheet finance" occurs when the originator acquires funds from the SPV which do not appear on the originator's balance sheet as borrowing. Even though the SPV borrows the funds from the capital markets and transfers it to the originator, the originator's balance sheet will record this acquisition as funding received in exchange for receivables sold or pledged and not as a strict borrowing since the received funds do not carry any risk or liability which would need to be recorded.

5. EVOLUTION OF SECURITISATION

The concept of securitising assets was developed in the US in the 1970's when the first transaction was launched. It involved mortgages, which were purchased from the secondary mortgage market by a special purpose vehicle. The mortgages were guaranteed by a government agency known as the Government National Mortgage Association (GNMA), which ensured the creditability of the bond issue and the overall structure. The process set the foundation for the future (Kravitt, 1996: 21).

During the 1980's securitisation was seen as a process which could enable other entities to raise finance or remove risk-embedded assets off its balance sheet; and the concept that any form of cashflow can be securitised was born (Schwarcz, 1994). Mortgages were a popular asset used in many securitisation deals and deals were creatively named. A pool of mortgages supported securities called "collateralised mortgage backed securities" (Standard and Poor's, 1993x). Alongside these deals, originators started to isolate pools of credit card receivables and used these as support to issue securities. For example, Citibank isolated a portion of its credit card receivables into a pool and issued securities backed by the pool. This enabled Citibank to remove risk-embedded assets of its balance sheet thus providing finance for other business operations (Moody's Investor Services, 2000: 4).

Securitisation structures are either based on existing receivables or future receivables. The difference is that a structure supported by existing receivables relies on rights to payments which exist or can be ascertained. The originator is party to a contract which has created an intangible asset. For example, a bank is a party to a contract for the provision of a mortgage. The mortgage repayments are based on an established payment pattern from which the bank can ascertain the amount and frequency of the repayments. This payment pattern assists the credit rating agency in determining the strength and reliability of the right to payments.

In contrast, future receivables are rights to payments which will come into existence at a future date or will potentially come into existence. For example, a film production company raises finance to fund part of the production costs. The film is yet to become an asset and its rewards are yet to become an intangible asset. Nevertheless, bonds may be issued supported by the predicted cashflow pattern since the credit rating agency will analyse the production company's ability to produce the film and market it appropriately in order to achieve the predicted rewards. The payment pattern and rights, although do not exist, can be predicted to materialise at a predictable date (upon completion of the film) or has a strong possibility of existing.

Securitisation of future receivables is perhaps a more risky transaction since the investors have to be convinced that they will achieve the stated return. The credit rating agency factors into its rating criteria the uncertainty of the materialisation of the predicted receivables – the asset which is to produce the predicted receivables may fail to produce them. Since the originator relies largely on its business plans to produce the predicted income, the credit rating agency requires additional external support to cover any miscalculations which later become apparent in the business plans. The risk for investors investing in securities backed by future receivables derives from the fact that the rating assigned to the securities reflects, in part, predicted business plans and, in part, the originator's ability to produce the assets. Conversely, securities backed by existing receivables are safer because the rating assigned reflects, in part, actual invoices awaiting payments and, in part, the originator's ability to pass on the receivables to the SPV. The credit rating agency will focus on where the risks exist.

It is interesting to note that a securitisation of existing receivables relies less on credit enhancement than a securitisation of future receivables. The reason behind this is that the pool of existing receivables consists of actual generated receivables which will materialise into a cashflow at a known date, whereas a pool of future receivables consists of a generated opportunity to produce receivables. In the former, the payment pattern can be predicted and any shortfall or weakness can be made good. In the latter, the payment pattern cannot be accurately predicted, save for the business plan, thus it is difficult to conceive the extent of any shortfall or weakness.

The future of securitisation is that it will continue to exist in a good economy for many more decades. Although, securitisation is hailed for its benefits, it does have a major restriction – it is only workable in a good economy and if all predictions materialise reasonably (Moody's Investor Services, 2000b: 7). In a suffering economy investors become sceptical and cautious about investments – they have a tendency to shift funds into secure investments. Capital markets are a safe investment, but a securitisation relies largely on the ability of the originator to pay the SPV and funds passing unhindered to the investors. The credit risk inherent in each receivable is a crucial risk which is assessed by the credit rating agency. If the receivable fails to pay then this ultimately impacts on the investors. For this reason the credit rating agency scrutinises the pool using worst case scenarios (discussed in chapter 2) to ensure that in a bad economy the investors are not affected or at least any loss can be measured and compensated for using external credit support. A good economy is essential to ensure that the underlying obligors pay what is due so that the receivables materialise from rights to payment to actual tangible assets which are ultimately passed on to the investors.

It is true that external credit support can be incorporated into the structure to compensate for any loss, but it is worth noting that this support is a carefully measured loss coverage package and is limited to those predictable losses which are associated with credit and structural risks. Thus, any predictions made need to reflect closely with reality. For example, in the late 1990's a number of credit card structures were causing losses and triggered external credit support to compensate investors (Moody's Investor Services, 2000b: 9). Although, testing scenarios were used to calculate the credit and structural risks, it is difficult to predict exactly how the pool will perform – the credit rating agency's testing is only guidance as to what loss to expect, it is not an accurate prediction of what to expect. Thus, the performance of the pool needs to reflect closely with the predictions made by the credit rating agency. A factor like a sudden global recession can not be predicted – the events of 9/11 could not be predicted thus, the post-global recession could not have been part of the testing criteria.

The securitisation industry has experienced phenomenal growth since its inception. Today, more countries are experimenting and utilising securitisation because of its benefits. But what has fuelled the growth? The two key reasons why an entity engages in a securitisation are either to raise finance which is favourably rated or to remove risk-embedded assets off its balance sheet (Moody's Investor Services, 2000: 5-6). A common reason for using securitisation in both scenarios is competition. Financial institutions strive to profit by offering a range of financial products which require a good balance sheet. For example, discounted loans and pensions funds require the financial institution to have sufficient capital and financial reserves. Thus, securitisation allows the financial institution to remove risk-embedded assets off its balance sheet and free up capital to cover another type of risk. It also provides finance instantly which can be invested in new projects. Globalisation and the surge in cross border activities have increased competition among financial institutions, and consequently has created opportunities for financial engineering. Securitisation allows the financial institution to increase its lending capacity without having to find additional deposits or capital infusion. The financial institution becomes more visible to the outside world and investors through the process of securitisation.

A non-financial entity also strives for profit and seeks new opportunities to prosper. Securitisation allows this entity to remove any risk-embedded assets off its balance sheet and gain access to instant funds. Further, the entity can gain access to favourable rated finance which is not limited to its corporate rating. Moreover, any dips in the economy may cause an entity to re-think and restructure its operations so that any loss can be compensated for by gaining from other opportunities. Securitisation allows an entity to gain funds and invest in new projects. Nations can also benefit by gaining access to finance using a rating that is higher than its sovereign rating.

Another strong reason for the growth of securitisation is the increasing shift towards seeking alternative financing sources as opposed to traditional commercial loans from financial institutions (Feeney, 1995). Downgrading in corporate and sovereign ratings has led entities to seek alternative financing options. Raising finance through securitisation does not rely on an entity's business operations – the focus is on the strength and reliability of the receivables which act as support for the bonds. A bond issue created through securitisation is rated according to the receivables as opposed to the entity generating the receivables.

6. FUTURE OF SECURITISATION

The future of securitisation is certain as long as competition exists and ratings of entities and nations continue to fluctuate. Ingenuity has created innovative structures which use various intangible assets. The following are a few ideas that the author suggests are the potential for securitisation.

1. *Repairing and developing infrastructures*: securitisation can allow a nation to repair and develop its economic infrastructure by utilising generated cashflows or potential cashflows to raise finance. For example, Iraq holds a rich supply of oil which can assist greatly in its development. The government of Iraq can create a company or a trust which owns the oil reserves and contracts with other nations to supply oil. The proceeds of these contracts will generate receivables and future receivables. These can be sold to a separate SPV who issues bonds to raise finance for developing the nation's infrastructure. The finance raised is not affected by Iraq's sovereign rating.

2. *Pensions*: Recent economic changes have affected pension funds in the UK to the extent that fund have lost value. Securitisation can be used to resolve certain problems in relation to pension funds. For example, assume a pension provider creates a scheme whereby pension seekers enter into an arrangement of depositing a fixed amount of money frequently into a fund. These deposits are receivables which can be used to support a short or mid-term bond issue to raise funds. The proceeds of the bond issue can be invested into a fixed interest bearing investment. The interest earned from the fixed investment can be used to pay interest on the bonds – the remainder is profit. After the life of the bonds the invested amount will continue accruing interest at a fixed rate. The pension seeker is then free to drawdown the pension and receive an amount which has not been greatly altered by economic conditions.

3. *Transport*: The falling condition of the London Underground has sparked many initiatives to re-finance for reparatory work. Proceeds from users can be used to support bonds and raise vital finance. Proceeds of the bonds can be proportionately split to handle operating and repair costs.

The next generation of securitisation structures may include substituting bond issues for bank borrowings. Instead of raising funds from the capital markets, the SPV may use the receivables to support repayments on a syndicate loan. The risk is spread amongst a syndicate of banks who are then free to transfer the risk on to others through a securitisation. Structures can be developed which can assist mergers – an entity uses the generated and potential receivables of a target entity to raise funds to purchase the target entity.

CHAPTER 2 CREDIT RATING AND SECURITISATION

1. INTRODUCTION

As stated in the previous chapter, securitisation is using the creditworthiness, collateral and cashflows of receivables as support for the securities. According to Standard and Poor's (1993r: 3), prior to any added enhancement, it is imperative that such support is sufficient to give potential investors the needed comfort to view the securities as a safe investment. Calculating the sufficiency of such support and evaluating the inevitable risks are tasks which an untrained potential investor is not competent to undertake. Additionally, because of the ingenuity and innovation of this type of financing investors need to have this technicalities of securitisation interpreted into terms which are understandable and disclose fully the risks involved, risks which are increasingly becoming distinct from those risks inherent in conventional bond issues (Standard and Poor's, 1993g: 5).

Therefore, an intermediary needs to interpose and undertake the tasks of calculating the amount of support needed and evaluating what risks are inherent in or can foreseeably be imposed on the securitisation structure which will consequently affect investors. This intermediary is a credit rating agency. Within the industry two rating agencies stand out for their experience and reputation for rating securitisation transactions, namely, Standard and Poor's and Moody's Investor Services. This chapter is based largely on their publications and detailed discussions with their rating analysts in London and New York.

2. CREDIT RATING

Because securitisation is a distinct form of raising capital through a bond issue, there are complex risks involved in the operation which are not necessarily inherent in a conventional bond issue. As stated earlier, the difference between asset-backed securities (the product of securitisation) and conventional bonds is that the former are supported by the creditworthiness, collateral and cashflows of receivables of an entity whereas the latter are supported by an entity's business performance. Although at first sight the two type of securities look similar, in that an entity's performance supports the securities in both cases (receivables can only be generated by performance), there is, however, a distinction visible upon close analysis.

In a conventional bond issue the rating agency will test an entity's business performance and its financial stability using worst case scenarios (discussed later in this chapter) which best reflect the risks exposed to investors in its business or securities. However, in an asset-backed securities' issue the rating agency will test the actual receivables using worst case scenarios which best reflect the risks exposed to investors.

Asset-backed securities provide interest and principal payments to investors solely from the payment pattern of the receivables. There is no other source of income for investors in asset-backed securities. Although credit enhancement facilities such as external guarantees and overcollateralisation may be incorporated into the structure, their primary purpose is to provide the SPV with liquidity whenever receivable payments for a particular payment period fall short of sufficiency (Standard and Poor's, 1993g: 3-5). Investors have no claim for payments from the originator of the receivables because the receivables have been legally assigned or pledged to the SPV – this is known as non-recourse finance because the SPV has no recourse to the originator, save and except where the transferred receivables have defaulted.

A rating agency will, typically, receive from an investment banker (on behalf of the originator) a request for a rating. On numerous occasions both parties will hold detailed discussions regarding, *inter alia*, the receivables, the structure and the economics of the operation. Numerous documents are reviewed by the agency before any indication of a rating is made.

The rating agency will view the securitisation structure from an investor's point of view. That is, will an investor receive the principal on maturity together with interest payments as promised by the issuer? The rating agency will scrutinise the securitisation structure to discover risks which may ultimately impede cashflows to the investors. According to both Standard and Poor's (1993r: 2-4) and Moody's (2000: 7-9) the risks inherent in a typical securitisation structure can broadly be named as collateral risk and structural risk.

3. COLLATERAL RISK

The SPV is an entity with no financial assets and structured so that it can only raise finance by using the receivables it intends to purchase as security and income. Therefore, the receivables it intends to purchase need to be financially strong in order to meet all of the SPV's obligations under the securities issue. Collateral risk analysis is associated with the credit quality of the receivables. From an analytical perspective collateral risk is any weakness in the collateral which will reduce its financial strength. Any weakness in the collateral, if not rectified, can affect the SPV's obligations towards investors and third parties such as the trustee, custodian and the paying agent. Each asset pool is distinct in nature and this distinction will dictate the type of collateral analysis undertaken and the type of structure used to amortise the securities.

Collateral analysis is ‘closely examining the ingredients of the pool of receivables and breaking each ingredient down to its core to ascertain, with near accuracy, the risks involved or that may be imposed on the pool of receivables through testing scenarios’ (Moody’s, 2000: 15-16). An example provided by Standard and Poor’s (1993a: 19) is, assume a pool of 100 mortgages, each with a life of 20 years and a yield of 6% p.a. (excluding principal). The ingredients of the pool consists of a 20 year long right to claim payments from a debtor, a benefit which financially provides interest at 6% p.a. and the aforementioned multiplied by 100. A critical analysis shows that, firstly, a 20 year long claim to payments can easily be cut short if the debtor becomes insolvent, secondly, the benefit of 6% p.a. interest can become a loss (an interest rise if the 6% is a fixed rate or an interest rate fall if the 6% is floating) and finally, if any debtor defaults and repossession results then the content of the pool will drop.

Collateral analysis scrutinises the collateral using historical data gathered by the rating agency concerning the type of assets in the pool. The data is used to show the performance pattern of a pool under normal economic conditions. Testing scenarios are then added to distort the performance patterns according to the desired rating. For example, assume a pool of 100 mortgages, each with a life of 20 years with a fixed yield of 6% p.a. Now assume that historical data dictates that over the life of the pool (twenty years) 20 mortgages will default and cease to exist within the first 10 years and thereafter there is an invariable reduction of 1 mortgage every 5 years from the pool. This historical default pattern is then used with the pool's contents to produce cashflow simulations of the pool throughout its life. If the pool can afford to pay the SPV's obligations then it is assigned a bottom rating - 'C' (Standard and Poor’s (1993a: 20).

If, however, the SPV wishes to have this rating increased then the rating agency will apply the testing scenario according to the desired rating. These scenarios assume the pool to experience worst-case economic conditions to establish whether investors will be paid as promised. The higher the desired rating the worse the economic assumptions made. The distinction in asset pools not only dictates the type of collateral analysis but also dictates the type of amortisation structure. That is, how the collateral is used as security and support the securities and pay investors. Assume that a pool is a large pot in which cashflows from the underlying debtors are consistently deposited in equal amounts over a set period of time. This pot of money is used as security and support for securities. The SPV can use this pot to amortise its obligations to investors by using either a cashflow structure or a market value structure. To determine which of the two is appropriate the rating agency undertakes a cashflow analysis and a market value analysis of the pot (collateral). The purpose of the analysis is to determine how the investors will receive their principal and interest payments in a timely manner. The analysis consists of examining both the life expectancy of the pot and the securities which the SPV intends to issue.

Both Standard and Poor's and Moody's believe that if the life expectancy of the collateral closely matches the life expectancy of the securities then a cashflow analysis will show that a cashflow structure is appropriate (Standard and Poor's (1993a: 34; Moody's, 2000: 19). The reason for this is that, assume a pot with a life expectancy of 5 years, that is, for a period of 5 years the pot will receive receivables. Now assume that the SPV intends to issue securities with a life expectancy of just under 5 years. The cashflow structure is appropriate because as receivables are deposited investors can be paid both interest and principal proportionately and this performance pattern can be forecasted. Normally, investors are paid interest during the interest-only period which is usually three quarters of the securities' life. After this period principal can either be paid proportionately with interest payments over the remaining period of the securities' life or in a lump sum just prior to the date on which the securities mature.

Alternatively, the pot of receivables can be used to pay the SPV's obligation using a market value structure. Again, the analysis for this structure also consists of examining the life expectancy of the pot and the intended securities. However, what determines this structure as appropriate is if the life expectancy of the collateral exceeds the life expectancy of the intended securities or issue programme. An example provided by Standard and Poor's (1993a: 38) is, assume a pot of mortgages with a life expectancy of 10 years. Now assume that the SPV intends on issuing short-term securities with a life expectancy of 6 years or a revolving programme in which two shorter-term securities of 3 years are issued consecutively. When the securities mature the pot still has a life expectancy of 4 years. The SPV can again issue another class of 3 year securities with 1 year remaining on the pot's life. This is when a market value structure proves beneficial in that the pot can be liquidated (the remaining assets sold in the secondary market) and proceeds used to amortise an issue. Under a typical market value structure the life of the pot exceeds the life of the securities. Interest is paid on the securities during the interest-only period and the received principal is reinvested in new receivables thus overcollateralising the structure. After the interest-only period has expired the pot is liquidated so that the principal is repaid when the securities mature.

Although there are minor variations in the way cashflow and market value structures are operated, these variations are usually due to the intended programme of issuance and how it is appropriately supported by the collateral.

Another factor, according to Moody's (2000: 22-23), which can influence the SPV to adopt a market value structure is if there exists an active secondary market for the assets in the pool – 'a pre-requisite' in the opinion of Standard and Poor's (1993a: 38). The SPV needs to ensure that if it decides to opt for a market value structure the remaining assets can be sold to meet the principal demand when the securities mature.

4. STRUCTURAL RISK

To recap, the collateral analysis examines the credit quality of the pot of receivables. The performance pattern of the receivables is dictated by the underlying contracts between the originator and debtors. Using historical data and testing scenarios the rating agency will have produced cashflows which forecast the performance pattern of the collateral according to the desired rating.

Once a collateral analysis has been conducted the rating agency's then conducts a structural analysis of the pool of receivables in order to ascertain the structural risks, that is, those risks which affect payments from the underlying receivables reaching the investors.

As Moody's correctly states, no two pools of receivables will behave in a similar manner (2000: 26-27). For this reason the rating agency will shape the structural analysis to suit the pool of receivables. The key concerns according to Moody's (2000: 28) and Standard and Poor's (1993r: 14) in the structure are:

- interest mismatch
- reinvestment
- loss allocation
- commingling
- cashflow allocation
- prepayment
- liquidity

The SPV will receive receivables at different yields. Some may be at a fixed rate while some at a floating rate based on underlying base rates. The securities it issues can either be at a fixed or floating rate but certainly with a lower yield than it receives on the receivables. Because of this difference in the interest rates – viewed as profit – the rating agency will suggest that this difference in the yields is deposited into a fund account and used primarily for expenses which arise periodically throughout the life of the SPV. The fund account must be with a bank rated at least equal to the securities. In the event that a bank becomes insolvent funds can be frozen in all accounts. Therefore, the bank's rating can affect the overall rating of the issue.

The concerns relating to prepayment and reinvestment are, often, viewed as related, in that whenever prepayment is triggered concern for reinvestment is consequently triggered. The performance pattern of a pool is, to a certain extent, dictated by the behaviour of the underlying debtors. It can easily be the case that a debtor prepays and fulfils its obligation prior to the expected date – typical situations include a debtor refinancing debts at a lower rate. The inevitable effect of prepayment is that the pool has decreased and received a lump sum of principal. Since prepayment is an event that cannot be accurately predicted, the SPV needs to safeguard the pool from falling below the required amount to meet all obligations. The safest way is to reinvest any prepaid principal in new receivables. However, there is the risk that the SPV may find it difficult to purchase similar yielding receivables to those that were prepaid. The rating agency will, however, offer guidance, using a criterion, as to the type of investment and yield needed to continue the cashflow pattern (Moody's, 2000: 29).

Prepayment is an event which can occur unpredictably during the life of the pool. Although historical data can indicate approximately a prepayment pattern of an asset pool, the SPV safeguards against this risk by purchasing additional receivables so that the structure is *overcollateralised* during the interest-only period of the securities.

Cashflow allocation is only a significant concern if no cashflow distribution mechanism is in place (Moody's, 2000: 29). The mechanism which facilitates cashflow allocation is devised by taking into account the performance pattern of the collateral, the payment pattern and structure of the securities. The degree of concern for the distribution mechanism will reflect the number of different classes of securities issued by the SPV. The SPV needs to ensure that if it issues a multiple class of securities, investors, regardless of their class of security, will receive interest and principal payments timely and fully.

However, subordinate structures (used to issue multiple class of securities) have an inherent advantage in that they can allow loss allocation to occur within the structure without an effect on the SPV. The loss is distributed to investors of the subordinate class of securities. Because these investors expect a higher yield than the higher class of securities they are exposed to a higher risk of non-payment. Usually, the subordinate class of securities is rated lower than the higher class of securities and in some cases they are known to be unrated thus, placing the risk of the securities entirely on potential investors. If the operation is a success then these investors can easily make a handsome profit but if it fails then these investors have more to lose and may not receive their expected return.

Once the receivables have been assigned by the originator, the originator will remain a party to the structure to the extent of acting as a servicer. The servicer is obligated to receive payments from the underlying debtors and convey these on to the SPV. As well as acting as servicer the originator also engages in its own business. This can easily lead to the originator commingling its receipts with those from the SPV's receivables. This concern becomes significant in the event of the originator's insolvency/bankruptcy because the originator's accounts and assets can be 'frozen' thus, causing a delay in the cashflow allocation. In practice, to safeguard against this risk the SPV will open a 'lockbox' account into which the originator deposits receipts. This account is cleared daily and proceeds are moved to the SPV's personal account. A 'lockbox' account is distinctive in that the originator can only deposit funds and not have access to the benefits whereas the SPV can only have access to the benefits and not deposit funds. Moreover, a 'lockbox' account cannot be treated as the originator's asset even if it can access the account for depositing (Moody's, 2000: 30-31).

5. Influence of Sovereign Rating on Securitisation

The aforementioned discussion focused on the analysis undertaken and risks inherent in securitisation structures. Although collateral and structural risk discovery is vital when assigning a rating, sovereign risk analysis has also become increasingly significant. During the infancy of securitisation, structures were composed in a manner that all participants and components existed in one jurisdiction. Now that securitisation has developed – 30 years later – this is not the case anymore.

Today, a typical structure incorporates international participants and cross border issuances. Because of this trend towards globalisation sovereign risk analysis is certainly an important and inevitable subject of analysis in asset-backed securities.

Sovereign risk analysis originally focused on the ability and willingness of a particular country's central bank to make available foreign currency on order for the government or corporate borrowers to repay foreign currency debt obligations (Standard and Poor's, 1993b: 3). The sovereign rating of a country reflects this ability and willingness. Because asset-backed securities have changed due to globalisation this original sovereign analysis is vital. Participants such as liquidity providers and swap counterparties need to be assessed with a sovereign risk rating in mind. A swap counterparty who is swapping currency needs comfort that foreign currency will be available for it to undertake its obligations under the swap. Similarly, a liquidity provider may be called upon to provide foreign currency and therefore needs comfort that foreign currency will be available.

However, due to the expansion of asset-backed securities in a global context, two other types of analysis have been incorporated into the sovereign risk analysis. These are domestic currency risk analysis and bank deposits in foreign branches risk analysis.

1. Foreign currency risk analysis

This analysis seeks to measure the ability and willingness of a country's central bank to make available foreign currency for borrowers to service foreign currency debt (Standard and Poor’s, 1993b: 4-5). The analysis is based on two possible scenarios, firstly, a country's borrower may default on its foreign currency debt obligation due to the country's deficient foreign exchange earnings, and secondly, there could be a sudden cashflow interruption in foreign exchange earnings thus, creating a liquidity problem. With these scenarios the rating agency will assess the likelihood of a borrower unable to convert its domestic currency cashflow into the required currency in the time required.

This analysis can form the basis of estimating long-term vulnerabilities in a country's pattern of generating wealth and the ability to repay foreign obligations. Political factors are also incorporated into the analysis to discover if a country's ability and willingness to repay foreign obligations are affected. According to Standard and Poor’s (1993b: 5) acts such as a radical change in leadership or trading policy can easily add weight to the significance of political factors in the analysis. Once these factors are assessed the rating agency can assign a sovereign rating. This sovereign rating acts as a "ceiling" for foreign currency denominated securities of any entity that falls under the country's political control. For example, assume that the UK has a foreign currency rating of AA, any entity regardless of how financially strong it is can only be assigned a maximum AA rating for any foreign currency issues. This is true even if the entity's domestic bonds are rated AAA (Standard and Poor’s, 1993b: 5). The reason for the ceiling derives from the fact that all foreign currency payments are under the control of a country's central bank. The central bank of a country has the legal power to impose controls on funds flowing in and out of its country.

Foreign currency risk analysis is undertaken in a structure in which the originator sells receivables to a SPV which then issues securities denominated in a currency different to the currency of the underlying receivables. The SPV needs to ensure that foreign currency is available to repay investors. In practice, SPVs (in similar structures) are located in countries with a high foreign currency sovereign ceiling so that the ceiling cannot limit the rating of the issue. Furthermore, banks are used which are located in countries with high sovereign ceilings and so are other parties who offer monetary support in foreign currency.

2. Domestic currency risk analysis

The analysis for domestic currency risk is different to foreign currency risk analysis. The main reason is that a government has more control over its own monetary, regulatory and legal environments than it has outside its sovereign jurisdiction.

The rating assigned to government debt acts as a ceiling to all domestic issues of any entity within the government's political control (Standard and Poor’s, 1993b: 7). Government debt is always assigned the highest possible rating due to the fact that it can easily meet its local currency obligations through taxation or money creation. Likewise, domestic currency obligations of a corporation are not subject to the same risks that are inherent in any of its foreign currency obligations. For example, foreign earnings can be withheld in political crisis. Furthermore, the central bank has no control mechanism for domestic currency like it does for foreign currency.

Therefore, according to Standard and Poor’s (1993b: 7) it is possible for an entity to have a domestic currency rating higher than its foreign currency rating. For example, Denmark’s domestic currency rating (as at 22 October, 1997; Standard and Poor’s, 1993b: 8) was AAA whereas its foreign currency rating is AA+ and is predicted as remaining stable. Other examples are, India with a domestic currency rating of BBB+ and a foreign currency rating of BB+ (as at 22 October, 1997; Standard and Poor’s, 1993b: 8) and the respective AAA/AA- domestic versus foreign currency ratings held by Portugal (as at 22 October, 1997; Standard and Poor’s, 1993b: 8). However, the analysis for domestic currency rating focuses on a number of factors including political and economic risks within the country itself.

3. Deposits in foreign branches risk analysis

In a typical securitisation the cash generated by receivables is held in trust in a deposit account at a bank. The deposits may become quite sizable and can affect the credit quality and rating of the issue. However, in many cross-border issues the issuer will deposit the cash in a foreign branch of a bank until it is needed to pay investors residing in that country. Because cross-border issues are becoming increasingly popular the assessment of monies held in foreign branches of banks is another part of the sovereign risk analysis which can influence asset-backed securities.

Each bank in its home country will have a deposit rating assigned based, in part, on that country's foreign currency and domestic currency sovereign ceiling. This deposit rating is reviewed periodically by rating agencies. However, in cross-border issues, how should deposits be rated if they are held in a foreign branch of a bank?

A foreign branch of a bank becomes subject to the sovereign power and legal environment of the branch's host country. Any deposits held in the foreign branch can only be rated (that is, acknowledged as a creditable source of monetary support for investors) if the host country has been assigned a sovereign ceiling for bank deposits. All of the much used financial centres of the world have sovereign ceilings for bank deposits (Standard and Poor’s, 1993b: 15-18).

In such cases the deposit in the foreign branch will be rated lower than either the rating of the parent bank or the sovereign ceiling for bank deposits of the host country. If the sovereign ceiling is lower than the rating of the parent bank then an unconditional guarantee could possibly raise the deposit's rating to the level of those in the home country. For example, assume a parent bank rated AAA with a branch in a country with a sovereign ceiling of BBB. If the parent bank provides an unconditional guarantee then the branch's rating will be raised to the rating it would have been assigned if it was operating in its home country (Standard and Poor’s, 1993b: 15-18).

In general, it is understood that banks are liable for claims on their foreign branches. However, actions of a host country may prevent the foreign branch from servicing its liabilities in a timely manner. In this instance the parent bank may be held to service the foreign branch's liability. However, because any deposit contract is governed by the host country's law, courts of another country can generally refuse to contravene the host country's sovereign authority, thus relieving the parent bank of the obligations of its foreign branch.

Therefore, in conclusion, issuers in cross-border transactions need to select with care foreign branches of banks which are used to deposit cash for investors or to route money around because the sovereign ceiling for deposit rating can certainly influence the overall rating of the securitisation.

CHAPTER 3 CREDIT RATING IN PRACTICE

This chapter seeks to demonstrate how different assets in a pool are analysed by the credit rating agency in order to establish a near accurate yet reliable indication of the risks associated with the assets.

The assets used for demonstrating have been carefully selected to reflect the difference in the rating agency's analysis. Securitisation has been undertaken using different types of assets which require different approaches when analysing credit and structural risk. This part of the chapter will demonstrate Standard and Poor's analysis respecting mortgage, credit card receivables, trade receivables, future receivables and synthetic securities.

1. MORTGAGES

Mortgages were the first type of asset used for securitisation (Standard and Poor's, 1993n: 1) and are ideal for securitisation purposes because of their inbuilt security of taking charge of the mortgaged property and furthermore, the proceeds of the insurance policy which covered any deduction in security.

1.1 COLLATERAL RISK

A rating agency will first assess the collateral risk, that is, the risk associated with the credit quality of the mortgages which support the securities issued. There are two main concerns which the rating agency underlying the rating agency's analysis. These are according to Standard and Poor's (1993a: 22-23):

1. *Delinquent payments* – which occur when the borrower fails to make the required payments; and
2. *Default* – which occurs when the borrower has defaulted severely so as to allow the lender to repossess the mortgaged property.

Both delinquent payments and default causes cashflow problems for the SPV. This consequently affects the investors as cashflow disruption will affect the timely conveyance of payments to the investors.

1. Delinquent payments

A credit rating agency will class delinquent payments or arrears as either short-term or long-term. Short-term arrears are those which consist of overdue payments amounting to less than two months, whereas long-term arrears are those which are in arrears for more than two months. Short-term delinquencies are initially viewed as the effects of administration errors or acts, such as a change in the borrower's direct debit instructions, which can easily be rectified.

However, they can also be the initial signs of long-term delinquency behaviour if not rectified within the first month of arrear. For example, in countries such as Sweden where banks do not have automatic debiting facilities this creates the potential for defaulting on payments (Standard & Poor's, 1993q: 3). Long-term delinquencies are observed closely as they provide a reliable indication of underlying asset performance from which projections of future liquidity and credit cover usages can be made. These projections need to be accurately made so as to prevent any downgrading of the rated issue.

However, arrears can be distorted quite easily (Standard and Poor's, 1993a: 23-24). Firstly, in a falling interest rate environment long-term arrears can be overstated. For example, if a borrower has arrears of £1000 and his monthly repayments are £550, the arrears will be classified as short-term because the overdue amount is less than two months of payments. However, if interest rates fall and the borrower's monthly repayments are reduced to £450, the arrears are then classed as long-term even if the total amount has remained at £1000.

Secondly, the decline in pool size over an issue's life can overstate percentage arrear levels. A pool reduces in size as mortgages repay and the non-performing mortgages remain at the same level. Thus, percentage arrear levels can increase while the absolute arrear values remain constant if performing mortgages are being redeemed from the pool. And finally, arrears can be artificially lowered by programmes in which lenders allow a capitalisation of a borrower's outstanding payments. This increases the value of an individual's loan while removing that portion of arrears from the lenders portfolio, even though no payments have been made.

2. Default

A borrower's performance pattern for any mortgage is, of course, dictated and influenced by external economic conditions. However, for a rating agency to predict performance by analysing every cause of economic effects is expensive and time consuming.

Therefore, the analysis is reduced to analysing four factors which relevantly affect performance (Standard and Poor's, 1993a: 24-25):

1. *Loan-To-Value (LTV):* The borrower's proportion of equity in the property is an incentive to continue payments. A borrower with a LTV nearing 100% will have

no personal investment or equity in the property and thus, no incentive to maintain a continuing payment schedule in a falling house price environment.

2. *Income multiple requirements:* This requirement plays a key role in any negotiation for a mortgage. The lender has a formula which calculates the maximum amount available for a particular borrower. The income multiplier will vary according to the salary scales, inflation and general economic conditions of a particular country.

3. *Products:* Innovation has played a considerable part in creating many types of mortgages. Today, investment linked mortgages are still a fashionable product and inbuilt assistance like deferred interest rates have helped more people become homeowners. However, as mortgage products advance, their analysis of risk differs to reflect their characteristics. For example, a deferred interest rate is a beneficial element for a first time buyer but the rating agency will take a negative view of this. Because first time buyers will be obligated to pay reduced or discounted repayments for the first 12 months (at least), historical data held by rating agencies shows that after the initial period of low interest payments comes a rise in interest payments. Borrowers are practically unaware of the floating rate interest that will be payable once the fixed rate period expires. Interest rates are reviewed monthly and adjusted accordingly. Therefore, lenders cannot speculate future rates when mortgages are first contracted for.

4. *Borrower's status:* The creditworthiness of borrowers in the underlying asset pool is, in part, an indication of the creditworthiness of the whole securitisation. Enhancement facilities are used to strengthen any shortfalls in credit at the initial stage. Due to huge losses sustained by banks during the 1980-90 recession in the UK, credit providers now use a tight credit criteria which effectively test each potential borrower's capacity to maintain a credit obligation. The rating agency will evaluate the credit criteria used by the lender when assessing the creditworthiness of the asset pool. Credit criteria will vary slightly to reflect each type of mortgage.

For example, a repayment mortgage involves the borrower paying principal and interest payments simultaneously and thus, requires a borrower with the capacity to maintain a consistent record of credit obligations, i.e. make timely payments of the required amount. However, under an endowment mortgage, the borrower will pay the lender interest payments only and assign the beneficial interest in an endowment policy to the lender. The onus is on the borrower and the fund manager of the endowment policy to secure sufficient capital to pay the principal when it is due. Because the principal is created by market forces acting upon a regular deposited amount in a fund, this is reflected in the credit criterion used by the lender to assess a potential borrower of an endowment mortgage. The credit criterion is slightly relaxed if the borrower invests in a fund with a reputable and experienced fund manager. This is often a condition precedent in the mortgage contract.

Self certification loans and non-status loans, however, require no credit checks and borrower assessment is based on very lax criterion. Usually a lower LTV ratio is imposed on borrowers so that the property has equity which can be used as a cushion to absorb credit risk.

1.2 CALCULATING LOSS

The rating agency's primary concern is the likelihood of investors receiving full and timely payments. Each pool of mortgages is analysed using historical data models which can predict the pool's performance. "Stress scenarios" are then added into the equation according to the desired rating. Stress scenarios are also called *worst case scenarios* (Standard and Poor's, 1993a: 25). In short they are equations which form part of a computer based simulation designed to calculate loss and the predicted performance of the pool of receivables. Worst case scenarios are highly confidential materials which, as stated by Christopher Such, Ratings Analyst, Standard and Poor's, New York, during an interview on 20 March, 2003, 'are never made public by any rating agency'. However, there are materials which a rating agency will release which demonstrate worst case scenarios but lack significant detail.

The credit loss of a pool of mortgages is calculated using the formula (Standard and Poor's, 1993a: 25):

foreclosure frequency X loss severity

Foreclosure frequency is the percentage of loans in the pool assumed to go into foreclosure (default) over the life of the issue. *Loss severity* is the assumed average loss realised on each defaulted loan. The foreclosure frequency is dictated by historical data showing percentages of predictable loan defaults over a period of time. Whereas loss severity is calculated using the cost of converting a defaulted mortgage into a repossession of the property and then adding to that amount the loss sustained due to declining property values or an auction sale, all in a worst case scenario.

1.3 ENHANCING

Credit enhancement facilities protect the principal repayments on the bonds that could easily be affected by losses made on the resale of any repossessed properties. A liquidity enhancement facility, conversely, ensures the timely payment of interest to investors when non-performing mortgages cause cashflow disruptions. Other than *overcollaterisation*, a pool of mortgages is, in practice, enhanced using two facilities (Standard and Poor's, 1993x: 4-6). Firstly, an insurance policy is arranged to cover a predetermined amount of potential defaults and associated losses. This policy provides credit loss protection and an appropriate bank facility will often provide the liquidity enhancement

Alternatively, a senior/junior structure is used (Standard and Poor's, 1993s: 2-4). Here, at least, two classes of securities are issued by the SPV – class A and class B. Class A securities have the right to claim first from the cashflows whereas, class B's claim to cashflows is subordinate. If there is a shortfall in cashflows then class A securities are satisfied first and any remaining cashflows are allocated to class B securities. However, a hybrid of senior/junior and overcollateralisation is commonly used to enhance the pool's creditworthiness. Repayment of class B principal is delayed until class A has been fully paid and matured. To do this all scheduled amortisation payments and unscheduled prepayments are used to pay class A while class B acquires the residual of the asset pool. The deferral of payment to class B securities functions like an insurance policy for class A security holders. However, the protection afforded by deferral is not as effective as the protection offered by an insurance policy. An insurance policy is liquid up to its coverage whereas the right to receive cashflows is illiquid. An insurance policy can pay for losses as soon as they are realised, whereas in a senior/junior structure cashflows may not be available to cover the loss immediately (Standard and Poor's, 1993s: 5). Additional enhancement for liquidity can be achieved by using any surplus from interest received and interest paid.

Any loss sustained by the pool is, as stated by Christopher Such, Ratings Analyst, Standard and Poor's, New York, during an interview on 20 March, 2003, absorbed using a three-tier cushion. Tier- one absorbs *first loss deductibles* by using a fund set aside by the SPV to absorb any initial credit loss. Tier-two will absorb further loss using mortgage indemnity policies. And finally, tier-three will absorb any remaining loss using a pool insurance policy.

1.4 CASHFLOW RISK

The quality of the securities issued by the SPV does not merely depend upon the riskiness of the receivables. It also depends on the structure itself used to channel the payments from the receivables through to the investors.

Cashflow models are used to test the cashflow streams under a variety of *worst case scenarios*. The higher the desired rating the more severe the model's assumptions. As a result, cashflow projections are produced which include the reduced cashflows together with all credit and liquidity supports. Cashflow projections are produced using differing worst case scenarios. Each projection is then analysed to calculate the need and extent of credit and liquidity support. This way a range of projections are produced and one is ultimately chosen which appropriately mirrors the intentions of the investment banker (Christopher Such, Ratings Analyst, Standard and Poor's, New York, during an interview on 20 March, 2003).

The cashflow must be sufficient to withstand loan delinquencies which, according to historical data, may continue for a period of up to six months before curing. Furthermore, the cashflows must withstand the impact of loans remaining in default for a period of up to 18 months before repossession realises any return.

Cashflow simulations are drawn up to represent cashflow allocation for structures primarily (but necessarily) incorporating a senior/junior structure. Credit loss and liquidity shortfalls are covered by junior notes. Cashflow simulations must prove that even under worst case scenario's junior notes and reserve funds will provide the necessary protection for the senior notes (Standard and Poor's, 1993s: 6-7). A typical simulation, as stated by Christopher Such, Ratings Analyst, Standard and Poor's, New York, during an interview on 20 March, 2003, shows credit risk, liquidity risk, reinvestment risk (resulting from prepayment) and payments of all fees and expenses. The cashflow simulations simulate a three year depression scenario with defaults occurring in the beginning of the first, second and third years of the depression.

The three year depression is assumed to occur at anytime during the life of the issue. The amount of defaults occurring during the three year depression is assumed to be 1/3 of the assumed default frequency (foreclosure frequency). Recoveries from repossession are assumed to be realised after the 19th month from when the default occurs. The amount recovered is assumed to equal the outstanding mortgage amount less the loss severity (the average loss realised on each loan converted to repossession). It is further assumed that short-term arrears (lasting up to two months) will occur during the three year depression period.

In the absence of a AAA rated guaranteed investment contract cashflows are assumed to be reinvested at a rate of LIBOR minus 5% (Standard and Poor's, 1993x: 6).

1.5 COVERAGE STEP DOWN

A pool contains loans with differing amortisation schedules. Any credit and liquidity cover provided will, over time, increase due to the pool reducing in size. Thus, a gradual reduction is needed for the credit and liquidity cover. An immediate pro-rata reduction is not allowed as this can result in a loss because prepayment can occur at anytime during the life of the issue. Therefore, based on historical data a gradual reduction is permitted only if two conditions are met, namely (Standard and Poor's, 1993x: 9-12):

1. the step-down can occur in the 6th year onwards provided no mortgage substitutions or conversions have been permitted.

2. if no greater than 25% of the available credit loss cover has been used.

If these two conditions are met then a gradual step-down occurs as follows:

year 6: 1/4 of the difference between the percentage coverage required on the initial pool and the percentage of the outstanding pool.

year 7: 1/3 of the difference between the current cover and the initial percentage cover required on the outstanding pool.

year 8: 1/2 of the difference between the current cover and the initial percentage cover required on the outstanding pool.

year 9: full step-down may occur so that the required coverage is the initial coverage percentage but is based on the outstanding pool amount.

For example, in year six:

Initial cover: 7%
Outstanding pool: 60%

60-7=53
1/4 of 53%= 12%
Therefore, 12% of the initial cover can be taken off

Issue size: £1,000,000

initial cover: £70,000
12% of £70,000 can be taken off

If substitutions are permitted then step-down cannot occur until 5 years after the full substitutions period. The minimum floor of the credit and liquidity cover should be the greater of £500,000 or two times the largest remaining loan in the pool.

2. TRADE RECEIVABLES

The securitisation of trade receivables was, it seems, inspired by the concept that any stream of cashflow can be used to support an issue of securities (Standard and Poor's, 1996: 2). The concept of securitising trade receivables may have taken birth following the workability and early success of securitisations involving pools of mortgages, a view taken by Standard and Poor's (1993k: 4). From a rating perspective each type of cashflow contains two significant risks, namely, credit and structural risk. A rating agency will view trade receivables as short-term assets with a life expectancy of 30-90 days (Standard and Poor's, 2000a: 5-7). The other significant disparity, when compared to mortgages, is that trade receivables lack the security element inherent in mortgages. If a buyer defaults the seller has no inbuilt recourse other than taking title to the underlying goods or pursuing legal proceeding to claim the outstanding amount.

Therefore, trade receivables are comparatively more risky assets than mortgages. Because of this added risk the rating agency utilises an analysis which best reflects the risks involved. The analysis of trade receivables commences with analysing the credit risk. Because of the unique characteristics of trade receivables, credit risk is composed of two sub-risks, namely, *obligor default* risk and *dilution* risk Standard and Poor's, 2000a: 5-7). The analysis then moves on to consider the extent of structural problems which, if not rectified, can affected cashflows reaching investors.

2.1 CREDIT RISK

This is the primary risk associated with all asset types and trade receivables are no exception. Because trade receivables contain unique characteristics credit risk is subdivided into two risks, namely *obligor default* risk and *dilution* risk.

2.2 OBLIGOR DEFAULT RISK

This risk addresses the likelihood of any debtor/customer defaulting on their obligation to pay for goods or services rendered by the originator, as seller/provider. Standard and Poor's acknowledges that it is difficult to ascertain the degree of risk because of the different industries in which trade receivables are generated (Standard and Poor's, 2000a: 5-7). Each industry produces receivables in different ways. Therefore, there is no standard analysis for calculating this risk across all industries. The rating agency views each transaction as unique regardless of asset type. The agency has, over time and with experience, produced a guideline analysis which it uses to analyse and assess credit risk – but modification is necessary where the asset type contains clear differing characteristics.

Obligor default risk is measured using historical data of the originator's business and industry. The analysis will focus on a number of considerations, amongst which include:

1. The originator's delinquency and write-off performance over a particular time, i.e. 5-10 years.
2. The originator's write-off/bad debts policy to see how long the originator holds on to debts before writing them off. The longer the holding period the more positive effect this has as this indicates the originator's willingness to work out accounts until all collection opportunities are exhausted.
3. The originator's *charge-off* policies are examined to find any discretionary favouritism which can invoke manipulation. Charge-off in this context means the writing-off of an account by the originator/seller as uncollectible. This is necessary as it determines the value of delinquent receivables. For example, longstanding customers can be forgiven for failing to clear accounts because of a special relationship whereas, other customers would be pursued until the relevant account is cleared.
4. Underwriting and collection policies are examined to determine the likelihood of delinquent receivables remaining delinquent.
5. Marketing and terms offered to customers are examined to calculate cashflow predictions.

An important threat which can severely affect credit risk is the bankruptcy or insolvency of the originator or seller of the receivables. If the originator/seller faces financial difficulty this can lead to a number of consequences:

1. Product/service quality is diminished because of the lack of funds to produce goods or services. This in turn affects the credit quality of that receivable. Customers may not pay for the goods/services, resulting in delinquent receivables or customers may ask for a reduction in the price or even a refund which increases dilution.

2. In order to attract customers and prevent competitors taking business the originator may modify its terms of business. This can affect cashflow because, for example, if extended credit is offered, there is an inevitable delay before receivables are materialised into cash.

3. If the securities issued are solely dependent on the cashflows (without dependency or with limited dependency on credit enhancement) then the originator's/seller's credit quality and its potential to generate receivables is analysed. Where the securities partly rely on the cashflow and partly on credit enhancement facilities then the credit quality of the seller is just as important as the credit quality of the credit enhancement facilities.

2.3. DILUTION RISK

Dilution means any non-cash reduction in the pool of receivables that is not caused by defaults or write-offs (Standard and Poor's, 2000a: 7). Typical examples include, refunding a customer, discounts (for example, 2% discount if account is settled within 7 days) and rebates. Rebates are goods given at a discount in order to market or promote them – for example, the sales staff of a shampoo manufacturer will sell its new shampoo at a substantial discount so the public will sample it and become potential users. This discount needs to be accounted for.

Companies use diluting methods in order to establish good customer relations and remain competitive. The degree of dilution will depend on products and industry practices. For example, clothing purchased from a reputable outlet should be of good quality. Failure to refund where clothing is not of expected quality will inevitably affect customer confidence and in turn affect cashflows.

Dilution is categorised as follows:

1. *Contractual* - Terms which are in the contract that can provide dilution, e.g. discounts and rebates.

2. *Variable* - Dilution invoked by non-contractual terms or factors. This is difficult to quantify but historical data is helpful.

2.4 OTHER RELATED CONSIDERATIONS

Trade receivables are different to other receivables used for securitisation. The difference is that trade receivables are non-interest bearing assets. Therefore, they only produce an amount of money which does not include any profit such as interest. Because of dilution risk expected cashflows can be reduced if discounts or rebates are given. This can leave the SPV with a purchased portfolio of receivables producing insufficient cashflows to pay for servicing fees, expenses and the purchase of further receivables. If servicing costs and other expenses are not settled timely the terms of their contracts may invoke a breach which can cause an early amortisation of the operation.

Reserve accounts are incorporated into the operation on the advice of the rating agency. A small portion of receivables can also be kept in reserve to meet expenses – cash may also be held in reserve. The amount of receivables held in reserve depends on the liquidity of the receivables. If the receivables generate cashflows rapidly then cash held in reserve is kept to a minimum. This is because the receivables can be converted into cash as and when expenses arise. Conversely, if the receivables do not generate cash rapidly then the reserve ratio is more cash than receivables.

Trade receivables have a tendency of displaying a high turnover and higher payment rates, that is, the rate at which each receivable converts into cash. Because of the rapid and large inflow of cash there is an inevitable risk, if not rectified, that this cash can easily be commingled with cash belonging to the originator. This can, of course, have serious effects on investors' demand for timely payments of interest and principal in the event of the seller/originator becoming bankrupt. Depending on the bankruptcy laws of each jurisdiction, at least, 2/30 of the portfolio, that is 6.6%, can be lost or held in the bankruptcy estate of the originator (Standard and Poor's, 2000a: 10-13).

A cost effective method of reducing or eliminating any risk of commingling is to set up a "lockbox" account in which the debtors of the underlying receivables deposit their obligations (Standard and Poor's, 2000a: 13). The lockbox account is set up to receive these payments and convey them on a daily basis to the designated account of the SPV. Where a trust is incorporated into the structure then the lockbox proceeds are passed on to the trust account.

The servicer, typically the originator, plays an important role once the receivables have been assigned to the SPV. Two issues arise with regard to the servicing agreement. The first issue relates specifically to the inability of the servicer to continue its servicing obligation. This can be for various reasons, but commonly, if the servicer does not timely convey the proceeds of the receivables to the lockbox account. To safeguard against this the original servicing agreement must include a contractual clause which provides for a backup servicer should the original servicer default or breach its obligation(s). The second issue is the fee for any substitute servicer. This should be stipulated in the original servicing agreement, thus allowing the original servicer to find a substitute for the same fee without renegotiation (Standard and Poor's, 2000f: 4-5).

2.5 STRUCTURAL RISKS

1. Revolving period

Typically, and assuming that the pool's performance pattern is constant and all collections received are used to repay investors, a typical pool of trade receivables will cease to exist in 60-90 days. However, to match the maturity of the repayment to investors with the intended funding strategy (which may be for a longer period of time, e.g. 12 months) it is necessary to extend the life of the receivable pool and the securities issued. Commonly, to do this, investors are paid only interest during the 'interest-only' period of the securities. During this period collections from the receivables which would otherwise be paid to investors as principal are reinvested in additional receivables of equal quality.

In this way the pool will maintain a level of receivables which would be sufficient to pay principal when the securities mature. Furthermore, this allows the originator and the SPV the opportunity to implement the intended funding strategy which, if extended, allows the SPV to issue a further class of securities and reinvest the proceeds to maximise the yield of the overall operation (Standard and Poor's, 2000a: 5-7).

2. Early amortisation events

From an investor's perspective terms included in the documents which provide for early amortisation are considered as enhancing a portfolio's credit quality. Early amortisation events are included to safeguard the investors against unexpected scenarios in which the investors may not receive the expected yield and principal from their securities. Typical events include the originator's bankruptcy; a material breach of representations, warranties or covenants which adversely affect the success of the transaction; servicing default; credit quality of the portfolio eroding; and a reduction of credit enhancement below the required level (Standard and Poor's, 2000a: 8).

The rating agency does not focus on the existence of such events incorporated into the transaction because the rating does not reflect the existence or importance of these events. The reason for this is that these events are contingency events – their likelihood of occurring has been forecasted by the rating agency through meticulous examination of the originator, its business, the receivables and all third parties included for monetary support. However, there existence may be disadvantageous as they invoke an early unexpected return of principal to investors. This can also prevent a long-term funding strategy of reinvesting principal to prolong the life of the pool (Standard and Poor's, 2000a: 8).

The structure needs to be structured correctly as an early amortisation can automatically occur if the amount of receivables in the pool falls below the required amount. This automatic trigger also triggers the prohibition of any release of cashflow to all parties until the pool is restored to its correct and required level.

3. SYNTHETIC SECURITIES

Synthetic securities are supported by a modified cashflow pattern of a pool of issued securities. The modification is brought about by incorporating a swap agreement, typically either the 1992 ISDA *Multicurrency-Cross Border Master Agreement* or the 1987 ISDA *Interest Rate and Currency Exchange Agreement*, which changes the cashflow support to match the yield and currency demand of a specific investor base. A swap agreement is an indispensable tool which allows the SPV to customise the cashflows so that the securities it issues are attractive to a certain market. For example, a UK investor with a need for Italian government credit risk, but not Italian lira exchange rate risk, can purchase an Italian government debt security modified to pay in UK sterling. A swap counterparty can provide the UK sterling payments in exchange for Italian Euro (Standard and Poor's, 1993h: 2).

Synthetic securities allow an investor to indirectly hold collateral which would otherwise be difficult or uneconomical to hold. Mexican government debt, for example, can only be held by qualified institutions resident in Mexico. By incorporating a swap international investors can reap the rewards of this debt by arranging a swap counterparty in Mexico (Standard and Poor's, 1993h: 2). Another significant advantage of synthetic securities is that they allow investors to circumvent withholding taxes by placing such liability risk on the counterparty.

The underlying collateral is, in essence, the centrepiece of the synthetic security. The swap that is added merely enhances or customises the cashflow pattern to meet specific yields or currency demands of investors.

3.1 STRUCTURAL CONSIDERATIONS

The rating analysis of synthetic securities is comparatively simpler than other asset-backed securities. The analysis does not incorporate a credit risk examination because the underlying assets or collateral are usually rated. Where the assets are unrated then an examination of the credit risk is undertaken. But to date, transactions have tended to include pools of assets which are rated because a rated underlying asset is comparatively safer and more attractive than an unrated underlying asset. Ultimately, the SPV will want to make the synthetic securities as attractive and safe as possible.

The rating of the synthetic security is limited by the lowest supporting rating of any entity participating in the structure (Standard and Poor's, 1993h: 4). The *supporting rating* is a rating assigned to any party or instrument used within the structure for monetary support. The lowest rating is the ceiling for the issue's rating. A rating assigned can be affected by the downgrading of any rating in the structure.

The issue's rating cannot be higher than the underlying collateral used to support the synthetic securities. However, it is possible to have the synthetic security rated higher than the underlying collateral by incorporating a swap agreement and emphasising it as the sole support (Standard and Poor's, 1993h: 5). If the swap is terminated the swap party must pay the issuer a termination payment which equals the principal and accrued interest payable on the rated securities.

Another important rating consideration is the currency of the proposed issue. An issue cannot be assigned a rating that is higher than the local currency sovereign rating. The reason is that the issuer's access to local currency is dependent on the sovereign's policies related to currency control. For example, a structure that 'swaps' UK sterling debt into a Hong Kong dollar security, with collateral and the swap counterparty rated AAA can only be assigned a AA rating if Hong Kong's local currency sovereign ceiling is rated AA (Standard and Poor's, 1993h: 6).

In cross border commercial paper transactions timing of payments is crucial (Standard and Poor's, 1993h: 8-9). Therefore, the swap agreement needs to be flexible to allow commercial paper investors to receive timely principal and interest payments. Because of globalisation, time zones are an essential consideration. The swap agreement needs to be flexible so as to accommodate time differences thus, allowing parties to perform their obligations without causing a default in the chain of events. For example, assume that,

1. the collateral pays at 9am Mexico City time
2. payments by the issuer to the counterparty are due at 3pm GMT
3. payments by the counterparty to the paying agent are due by 4pm GMT
4. payments by the paying agent to security holders are due at 5pm GMT

In this example, by the time the collateral pays, the issuer is already in default on its payments to the counterparty because its payments were due to the counterparty at 3pm GMT which is 8am Mexico City time - assuming a 7 hour time difference.

The SPV's legal title to the securities supporting the synthetic securities is evidenced merely by a book entry in a clearing system – an organisation with which securities are deposited for safekeeping and through which purchase/sale transactions are handled. The two foremost systems are *Euroclear* and *Cedel* (Standard and Poor's, 1993h: 9). The SPV cannot, due to market practice, participate in the clearing system directly. Therefore, a custodian is appointed who acts as a link between the SPV and the clearing system. The custodian holds the collateral for the SPV's benefit. When the issuer grants a security interest in the collateral to the trustee for the investors of the synthetic securities, the trustee cannot take possession of the certificated securities that represent the collateral for its security interest to attach and perfect. Instead the trustee will hold its interest through the SPV's custodian. Therefore, there exists a risk which can disturb the cashflows. This risk is if the custodian goes insolvent or bankrupt will the investors receive timely payments (Standard and Poor's, 1993h: 10-11).

Synthetic securities involve custodians at two levels. At the first level the custodian holds the collateral as a direct participant in a book entry system on behalf of the SPV. The custodian is usually an agent bank resident in the jurisdiction where the underlying collateral was issued. The second level is where the beneficial interest in the collateral is held in a "sub-custodian account" with a participant at a recognised clearing system.

The SPV instructs the custodian to perform certain administrative duties in relation to the collateral for the benefit of the trustee throughout the life of the synthetic securities. The custodian will usually open two accounts, namely, "a securities account" in which the collateral is deposited and, a "cash account" in which collections deriving from the collateral are deposited. A third account can be opened in which withholding tax recoveries are deposited. The amounts deposited in the cash account are immediately transferred to the swap counterparty's account. There are two requirements which the custodian must comply with:

1. the "securities account" must be inaccessible to all parties.
2. the custodian must not commingle the collateral or any collections with other assets it holds for clients, or deal freely with them.

Once the custodian agreement is in place the SPV will give a security interest in the collateral to a trustee if a trust is used to issues certificates. The security interest must give first priority perfected interest to the trustee in the collateral. The security interest must also be legal, valid and binding under the chosen law of the jurisdiction.

The custodian agreement usually states that if the custodian's or its parent's rating is downgraded below A-1 or A then the accounts held by the custodian for the SPV should be moved to another appropriately rated institution within a 30 day period.

Other typical third parties involved in the structure are:

1. Trustee
2. Agents
3. Management company
4. Bank account providers

Third parties do not need a rating as long as they are not relied upon to provide the SPV with any monetary support (Standard and Poor’s, 1993c: 15). If a rating is required the general rule is that the long-term unsecured debt rating must be at least equal to the rating of the issue. Replacements for third parties must be provided for in the documents should a third party fail to perform due to insolvency, bankruptcy, downgrading of its rating, resignation or removal by the issuer.

The trustee's role is to safeguard the investor's interest in the collateral. The trustees do not involve themselves with the day-to-day administration of the underlying collateral and payments. Therefore, they will subcontract these duties out to professionals who undertake these duties. These professionals include the custodian, paying agent and a management company.

There are four different agents involved in the operation (Standard and Poor’s, 1993c: 17-19). Each agent undertakes distinct duties. The paying agent makes all payments of principal and interest related to the securities. It also prepares financial reports for the trustee's benefit and notifies if the swap counterparty has defaulted. A calculation agent makes all the necessary calculations regarding principal and interest payments. The registration agent will register the notes with the appropriate authority and holds the documentation while the notes are in bearer form. An authentication agent will authenticate the notes according to the documentation.

The issuer will pay the collections to the paying agent and this payment constitutes payment to the investors. After this the agent is responsible for conveying the correct amount to the investors. Agents do not need a rating because they have no set-off rights against, or security interest over the payments received from the issuer.

The management company will handle all the administrative operations of the SPV such as it will prepare and audit reports for the benefit of all third parties involved; handle all matters relating to the SPV's tax liability; ensure the SPV does not breach any obligations; and manage the SPV's bank accounts and any surplus income. A bank will provide accounts for any surplus income. The bank should be rated as it provides monetary support to the SPV.

3.2 TYPE OF STRUCTURES

There are two type of structures which create synthetic securities, namely, *swap dependent* and *swap independent* (Standard and Poor's, 1993h: 13-19).

3.3 SWAP DEPENDENT STRUCTURE

In this structure the cashflows forwarded to the investors derive from the swap. Thus, the swap is a major component in the structure. Because the swap plays a significant role in generating the end cashflow it is important to analyse the source of this cashflow. The source is the swap counterparty. The swap counterparty is rated so as to determine whether it has a good credit standing and can be relied upon to forward cashflows to the swap mechanism. The swap counterparty is called a "supporting rating" because the SPV relies on it for monetary support.

In a swap dependent structure the supporting rating is important as it indicates the overall rating of the whole operation and more importantly, indicates the rating of the synthetic security. The rating assigned to the synthetic security is the lowest rating of all those assigned to the supporting ratings (if there are multiple counterparties) and the underlying collateral.

Swap dependent transactions fall into two categories (Standard and Poor's, 1993h: 13):

- *Structures that analyse the credit risk of the underlying collateral*
- *Structures that do not*

1. Structures that analyse the credit risk of the underlying collateral

When the structure includes a supporting rating, the credit risk of the swap counterparty, the underlying collateral and the transaction's structure are important considerations as all these affect the customised cashflow going on to the investors.

The counterparty performs only its expected obligation which is to modify receipts into payments as stipulated in the ISDA agreement. The ISDA agreement is modified so that it is only slightly deviated from the market standard. This deviation is necessary to accommodate the nature and desires of the parties (Standard and Poor's, 1993d: 5). Investors need assurance that the swap agreement will not be breached or terminated by the counterparty. Therefore, the rating agency reviews the default and termination events in the ISDA agreement as chosen by the parties.

The ISDA agreement is a lengthy agreement which contains numerous clauses that collectively give the effect of a swap. To mention all the clauses would be irrelevant to this thesis. However, what follows are the clauses that are modified to get the desired effect (Standard and Poor's, 1993d: 6-10). The provisions that are not mentioned should be taken as they are in the ISDA agreement.

1. *Section 2 – Netting:*

   The party that owes a higher swap payment to the other can make a net payment. That is, a payment which is equal to the difference of payment made and payment received from the other party. Netting should not apply to currency payments or different series of securities issued by a vehicle.

2. *Withholding Tax:*

   It is standard practice under the ISDA agreement for parties to gross up swap payments if an indemnifiable tax is imposed on the payments. Withholding tax is an example of an indemnifiable tax. If there are provisions stipulating the imposition of a withholding tax then the swap counterparty must pay payments that are grossed up, to take into account the withholding tax, to the SPV and accept payments from the SPV that are net of tax. The reason why the SPV pays net of tax is that it has insufficient funds from which to pay the grossed up amount. If a third party is involved which guarantees the counterparty's obligation then the payments should be made and received as though the third party is the counterparty. Where there are no provisions stipulating the imposition of a withholding tax then legal opinions should express this.

3. *Section 3 – Representations:*

   Representations are allowed into the agreement only after due diligence. After modification any breach of these representations by the SPV shall constitute an event of default or allow the counterparty to terminate the swap. Unfair it may seem but it puts the burden on the counterparty to ascertain the credibility of the SPV's representations so that the investors are protected from termination events which result from facts that could have been discovered had the counterparty exercised due diligence before entering into the swap transaction. Part (a) of Section 3 sets out the basic representations that are made by the parties. These relate to status, consents, powers, no conflict and binding obligations. Because the SPV is a bankruptcy remote vehicle as opposed to an operation vehicle, it is continuously dependent upon third parties to perform its duties. Failure by any third party to perform will have a direct effect on the SPV's representations made in s.3. Therefore, it is important that the rating agency is assured that the structure is put together in such a manner which provides maximum protection to the structure.

2. Structures that do not rely on collateral analysis

Synthetic securities can be structured so that they do not rely primarily on the collateral as a source of repayment. To accomplish this the structure will incorporate a swap which has been structured flexibly so that it deviates greatly from the market standard. It is possible to view the swap as the primary source of the repayment for the securities (Standard and Poor’s, 1993h: 16).

Because the swap is the significant source the swap counterparty is a supporting rating. The terms of the ISDA agreement are modified to the extent that a termination of the swap results in the swap counterparty paying a termination fee to the SPV. This fee is equal to the principal and accrued interest payments for the life of the security minus proceeds from the sale of the collateral. In practice the formula for calculating a termination fee under section 6 (e) is modified to allow such a fee calculation to deviate from the market standard (Standard and Poor’s, 1993d: 5).

3.4 SWAP INDEPENDENT STRUCTURE

In this structure a swap is used to transform collateral payments into specific payments. The rating agency is not too concerned with the swapped cashflows as much as they are with the unswapped cashflows (Standard and Poor’s, 1993h: 17).

The collateral is the significant and primary source of payments. The swap is incorporated merely to shape the cashflows according to market demands. Therefore, if the counterparty defaults the whole transaction terminates and the collateral is liquidated to give investors a pro rata share or the swap terminates and passes any unswapped payments on to the investors. In both cases the investors are warned about the consequences of the counterparty defaulting. Because the underlying cashflows are the source of monetary support, the counterparty is not viewed as a supporting rating (Standard and Poor's, 1993c: 15).

In the case of a swap dependent structure the collateral is analysed because it is composed of quality bonds which have a high investment rating. If these bonds default then the counterparty can not really do much to pay the investors. The counterpart pays transformed payments to the investors as long as the collateral pays. The counterparty will need to exercise due diligence with regard to the likelihood of the collateral paying. If the collateral defaults then the counterparty loses out because it will have to pay a termination fee (Standard and Poor's, 1993d: 14). However, if all goes well then the counterparty can profit because junk bonds pay a high yield from which the counterparty can profit.

In the case of a swap independent structure the collateral is usually of good quality and the counterparty merely transforms cashflows so that they meet investor preferences. If the counterparty defaults then the collateral will still be sufficient to continue payments to the investors. The investors in this case can either accept unswapped income or their pro rata share of the collateral.

The effect of the swap terminating leaves the investor in no worse position than if it had invested in the underlying collateral. However, the economic impact of the termination depends on the market environment at the time of the termination (Standard and Poor's, 1993d: 16). For example, if interest rates are rising then the investor will lose out because instead of receiving the enhanced rate it will only receive the fixed rate of the underlying collateral.

4. CREDIT CARD RECEIVABLES

4.1 CREDIT RISK

The rating agency will first examine the originator's operations to calculate the initial quality of the receivables and the possibility of generating further receivables. The actual calculation of credit risk is done by running cashflow simulations of the receivables using five variables. Implicit in the cashflow simulations is an assumption that a *base rate* pay out event will cause the transaction to amortise. A *base rate* is the annual rate equal to the rate of interest paid on the bonds plus servicing costs. The pay out will occur when the 3 months average portfolio yield, less all losses, becomes insufficient to cover interest payments and servicing fees for the same 3 months period (Standard & Poor's, 1997: 5). The five variables are the payment rate, charge offs (losses), purchase rate, portfolio yield and certificate rate.

1. Payment rate

This is the rate at which monthly principal is repaid by the cardholders expressed as a percentage of their outstanding balance. The payment rate is an important indicator of how an issue will behave during the amortisation. During the amortisation period principal is collected and used to pay the investors. Simultaneously, credit enhancement levels are reduced at a pace that equals the amortisation.

If the payment rate is low then more losses are realised because there is insufficient principal to pay over to the investors and thus credit enhancement needs to be high. However, if the payment rate is high all principal that is collected can be passed to investors and simultaneously credit enhancement levels can be reduced to reflect the pace of the inflow of the principal (Standard & Poor's, 1997: 7).

2. Purchase rate

The pooling and servicing agreement in a securitisation transaction governs partly the continuous acquisition of new receivables. This is because as collections are received the amount of receivables in the pool are decreased. If no receivables are purchased then the pool may eventually consist of insufficient funds to pay principal and interest. Therefore, it is necessary to purchase new receivables. This method of maintaining a sufficient pot of funds is also viewed as a form of credit support for the SPV called *reinvestment* (Standard & Poor's, 1997: 7-8). The acquisition of new receivables and the rate at which they are purchased depends upon, firstly, the payment rate and secondly, the seller's business and performance characteristics.

If the payment rate is high then the purchase rate should, at least, equal this rate. For example, assume that the payment rate of a pool is 10% monthly. The purchase rate should be 10% to maintain the pool at its initial level. If the purchase rate was less than 10% then other forms of credit support are necessary so that investors can receive principal and interest payments timely. If the purchase rate is higher than 10% then this will accelerate the whole process of receiving payments and passing on those payments. Therefore, the general rule is that the purchase rate must be at least equal to the payment rate otherwise other forms of credit support are vital.

The seller of the receivables is also important because the seller needs to produce new receivables which it can sell to the SPV. If the seller becomes insolvent then this affects the SPV's ability to purchase new receivables. The SPV has rights over receivables which have been generated but not yet passed over to the SPV because such rights exist in the pooling and servicing agreement. Furthermore, this right to new receivables may be a secured interest in the new receivables so that the SPV becomes a creditor to the seller. Post-insolvency receivables may be difficult for the SPV to claim a right over (Standard & Poor's, 1997i: 9).

In the servicing agreement there are clauses which require the servicer to allocate collections from the receivables to the trust as though the trust owns all the receivables. If this is contrary to law then the agreement calls for an allocation of all collections from each account (cardholder) to be used to pay off the oldest balances. Because the trust has ownership in the receivables it holds, this form of allocation is advantageous than a pro rate distribution.

3. Charge offs

Charge off is jargon that means to "write off" a debt as uncollectible (Standard & Poor's, 1997: 9). The rating agency will examine historical portfolio statistics together with the underwriting and servicing quality in order to calculate the steady-state level of charge offs. The steady-state tells the SPV the rate of charge offs to expect in a given transaction. These charge off rates are stressed according to the desired rating sought by the SPV. For example, for a single 'A' rating charge offs are stressed ultimately to reach 2-3 times the steady-state level of charge offs. For a 'AAA' rating the steady-state levels are stressed so that ultimately it is 3-5 times the steady-state level (Standard & Poor's, 1997: 10).

4. Portfolio yield

The is the sum of finance charges, fees and interchange expressed as a percentage of the outstanding receivables balance and multiplied by 12 (Standard & Poor's, 1997: 10-14). Portfolio yield consists of three types of payments:

1. periodic finance charges
2. fees
3. interchange

Periodic finance charges are the interest cost associated with an unpaid balance at the end of a grace period. Fees include annual membership fees, late payment fees and over limit fees. Interchange is the fee paid to originators by VISA or MasterCard for absorbing risk and funding receivables during the grace period. Since there is no set rate for interest charges and originators can offer differing rates it is difficult to ascertain exactly what the portfolio yield will be for any given transaction. Therefore, the rating agency will assume that the yield will be between 11-12% in a AAA scenario.

Interchange fee is paid to the card-issuing bank (originator) by VISA or MasterCard as compensation for assuming credit risk and offering a grace period. The interchange income is created when a merchant's bank discounts the amount it pays to merchants for credit card charges. This amount of discount is shared between the merchant's bank, the originator and VISA/MasterCard as compensation for utilising their clearing house function. The originator's share of interchange income is actually generated during its settlement with VISA/MasterCard.

The originator's share of interchange income has an impact on the performance of the SPV's portfolio. Typically, the originator will agree in the servicing agreement to pass on to the SPV a *pro rata* share of the interchange income. This resulting in the SPV receiving supplemental cashflow which is recharacterised as finance charges and used to pay for transaction expenses. If structured this way this income can provide the SPV with extra loss coverage by creating a greater level of excess spread. However, the rating agency will not give any recognition to this extra income because the income can be stopped upon the originator's insolvency. Two issues elucidate the problem with interchange income:

1. The property rights of the originator in an interchange arrangement is not clearly defined in the membership agreement with VISA/MasterCard; and
2. Interchange fees are subject to set-off by VISA/MasterCard.

Because VISA/MasterCard are not parties to the transaction they provide no representation, warranties or covenants relating to interchange fees. Furthermore, VISA/MasterCard revise their interchange rates annually.

A servicer may offer to have a portion of their servicing fees paid from interchange income so as to reduce the required level of credit enhancement. In practice, the servicer and the SPV contractually agree in the servicing agreement to have, for example, 1% of the servicing fee paid from interchange income, if it is available. If the servicing fee rate is 2% annually then, if the interchange income is not available, the servicer is only allowed to collect 1% from the cashflows as servicing fees. This way the SPV can reduce its expenditure only if interchange income is not available and the following conditions are met:

1. For investment grade rating the SPV must have a servicer and a trustee (and successor servicer) willing to be paid a portion of its servicing fee from servicer interchange. Both must have high long-term senior unsecured debt rating and both must accept a reduced servicing fee if interchange is not available in the future. The rationale is that one of the highly rated entities should be available to service the portfolio at the lower servicing fee.
2. The trustee must have credit card servicing capabilities.

The trustee must find a suitable replacement for the servicing obligations should a replacement be needed. The rating agency will assume that the trustee will not find a replacement at the contracted fee and therefore will need to undertake the role itself. For this reason the trustee must have experience in servicing a credit card portfolio. In practice, the servicing obligations are done by the originator and the trustee is most commonly a trust company. If the trustee does need to take the role of a servicer then the originator will assume the role. If these conditions are satisfied then the rating agency will assign value to the interchange income which otherwise would be viewed as contingent upon the seller solvency. The rating will depend on the servicer's and trustee's rating and can be downgraded if either party's rating is downgraded.

4.2 STRUCTURAL RISKS

The originator conveys receivables to the SPV for the benefit of the investors. The account from which the receivables are conveyed remain the property of the originator and the SPV has property rights on the receivables only (Standard & Poor's, 1997: 16). The conveyance of the receivables include the amount of receivables in the account on a specific cut off date. Further, in the documentation, the originator agrees to convey any receivables that arise in those accounts subsequent to the cut off date. The accounts and the receivables are subject to an eligibility criteria and specific representations and warranties of the seller. Under an "account additions" clause in the servicing agreement the originator is obliged to add accounts when receivables fall below the minimum level allowed by the pooling and servicing agreement. If this does transpire then all collections received are placed into an *excess* or *spread* account until further accounts are added. This clause allows the "purchase rate" to be calculated and implemented.

4.3 THE SIGNIFICANCE OF A SELLER'S INTEREST

Typically, the SPV will issue two or more series of securities when using credit card receivables as support. Each series of securities issued may have two undivided interests. Firstly, the SPV has an undivided interest in the pool of receivables. Secondly, the SPV has an undivided interest in the collections of the receivables. These interests are based on the invested amounts of each series in the pool of receivables. For example, assume series A securities are issued and proceeds amount to 60% of the pool's interest. Series B securities are issued at a higher rate and proceeds amount to 40% of the pool's interest. Series A securities have been issued in a larger number than series B therefore, series A holders have the right to demand more money from the pool. Both series have an undivided interest in the pool, that is, they both have rights to the receivables and collections without priority.

There is also another interest which is not allocated to any series. This interest is allocated to the seller of the receivables (Standard & Poor's, 1997: 18-21). The interest held by the seller will fluctuate according to the liabilities of the SPV and the balance of the principal receivables in the pool. The seller's interest increases when the seller sells additional receivables to the SPV which are more than the necessary to meet payment demands, that is, when receivables are sold in excess of the purchase rate. The seller's interest decreases when account payments exceed account purchases. The seller has only an interest in the pool whenever the account purchase rate (the calculated amount reinvested in new receivables) exceeds the account payment rate (that is, the amount of receivables sufficient to allow investors timely payments and allow all expenses to be met timely).

The seller's interest exists because the SPV will need additional receivables and as part of the consideration provided for additional receivables the SPV allows the seller to have an interest in the trust. The purpose of this interest is firstly, to provide *overcollateralisation* when account payments exceed account purchases and secondly, to absorb reductions in the receivables balance that result from receivable dilution and non-complying receivables (Standard & Poor's, 1997: 23). Examples of dilution include merchandise returned and credit amount owed by the cardholder, eliminated reductions of amounts caused by rebates, refunds, adjustments for service errors or reductions resulting from fraudulent use or counterfeit charges. Non-complying receivables are those that were in breach of the representations made by the seller when sold to the SPV. In typical transactions the seller of the receivables absorbs the risk of dilution and all subsequent adjustments. During an amortisation any reduction in the receivables balance resulting from dilution would certainly hinder the payment of principal and interest to the investors. Because credit support is available to cover loss there is a tendency to keep this support to a minimum, that is, sufficient to cover the loss predicted. Dilution is not covered for by credit support so therefore the securitisation of credit card receivables needs to be structured so that a seller's interest, although kept at its minimum, is available to absorb the risk of dilution should the seller default on its obligation to absorb the dilution risk.

Most transactions incorporate a minimum seller's interest of 7% (Standard & Poor's, 1997: 23). Any deviation from 7% norm is based on an analysis of the historical performance of dilutions and the in place of a mechanism which will trap principal payments into an account at any time if the seller's interest falls below the specified minimum.

The rating agency will also analyse what is increasingly becoming popular in the competitive credit card market (Standard & Poor's, 1997: 25). This is rebate programmes. These programmes are setup to allow cardholders to earn points every time a credit card is used to purchase goods or services. They also allow the cardholder to earn points if he/she maintains a specified account balance. Once points have been collected the cardholder can redeem them for a variety of items including cash or airline tickets.

Because the card-issuing bank can become insolvent a rating agency views rebate programmes as imposing an additional risk to the structure. If the card-issuing bank does become insolvent it cannot continue with its obligations under the rebate programme, i.e. redeem points for items. In this situation the cardholder who has collected points may set-off the points with his current card balance. For example, assume Mr Smith has a card balance of £1000 and has collected £100 worth of points under the rebate programme. If the card-issuing bank then becomes insolvent and defaults on its obligation under the rebate programme, Mr Smith can set-off his £100 cash rebate against his card balance of £1000, thus allowing Mr Smith to settle his balance by paying £900.

The set-off in the scenario comes under dilution because there is a reduction in the receivables balance for a reason other than charge-off or cash payment, that is, the cardholder settling his balance by making the required payment. The rating agency examines meticulously each rebate programme incorporated into the receivable pool to calculate the likelihood of set-off occurring. Further, it will also examine whether any rebate programmes are prohibited by the credit card agreement, that is, whether set-off is allowed by the agreement.

Receivables derive from a range of sources including merchandise bought, services rendered, cash advances and balance transfers. Receivables from merchandise purchases can be subject to dilution because the merchandise can be returned. However, receivables from services rendered can not be subjected to dilution risk because there is no return of service offered. This is also similar for cash advances as money advanced cannot be returned if not needed. Balance transfers have become a fashionable method of enticing cardholders to transfer their credit acquiring activity from bank to bank. Low introductory APR's are offered to entice transfer. The popularity of balance transfers has an impact on the structure to varying degrees. Generally, portfolios which include a high rate of balance transfers will demonstrate a lower dilution risk rate because balance transfers are viewed like cash advances - they cannot be returned (Standard & Poor's, 1997: 26).

The rating agency will analyse 3-5 years of monthly return and fraud data with a particular emphasis on both the amount and timing of dilution. The required seller's interest is the amount necessary to protect investors from the loss resulting from dilutions during a rapid amortisation. It is assumed by the rating agency that a majority of the dilutions will occur within 1-3 months of the sale date of goods (Standard & Poor's, 1997: 28).

4.4 PAY OUT EVENT

The credit rating agency will also examine *pay out events* that are included in the receivable purchase agreement (Standard & Poor's, 1997: 29-36). A *pay out event* is called a *termination event* which, if occurs, results in the early redemption of the issued securities. The most common events are as follows:

1. *Base rate trigger:*

This is a pay out event when the excess spread, that is, the difference between the interest on the receivables and the interest on the securities, has eroded significantly. The base rate trigger usually comprises of two components (a) the net portfolio yield (finance charges minus charge offs that is expressed as a percentage of the investor's interest) and (b) the base rate (an amount of monthly interest, servicing fees that is expressed as percentage of the investor's interest). If the base rate exceeds the net portfolio yield for a 3 month period, the principal will be returned to the investors as quickly as possible beginning on the next distribution date, that is, the date when an interest payment would have been made in absence of a base rate trigger. Base rate triggers can be structured so that they cause a pay out event to occur before the excess spread declines to zero. For example, a trigger may require a pay out event if the net portfolio yield declines below the base rate plus 1% which would result in the transaction going into rapid amortisation sooner. With this type of structure mechanism credit enhancement can be kept to a minimum. The base rate trigger is an automatic pay out event which does not require the investors to vote.

2. *If the seller's interest falls:*

If the seller's interest falls below the required amount and not rectified within 10 days then this causes a pay out event. It can be rectified by adding additional receivables. The seller's interest is measured as a fixed percentage of current principal receivables or current investor interest. As a series of securities amortise the invested interest and seller's interest begin to decline. This type of pay out event also does not require the investors to vote.

3. *Failure of the seller's obligation:*

If the seller fails to make or deposit payments as required under the pooling and servicing agreement for a period of more than 5 days this causes a pay out event. Further, if the seller breaches a covenant which has material adverse effect on the investors and left unremedied for 60 days this also causes a pay out event. This requires investors representing 50% of the invested amount of a series of securities to vote in favour of a pay out event before it can become effective.

4. *Representation & Warranties*:

A pay out event will occur if there is a material breach a representation or warranty by the seller which remains unremedied for 60 days. This also requires 50% of the investors in a series to vote in favour.

5. *Servicer default:*

If the servicer of the receivables defaults causing a material adverse effect on the investors then this is a pay out event requiring 50% of the investor to vote in favour.

6. *Investors are not paid in full and timely*:

If any class of security holders is not paid in full and timely then this inevitably triggers a pay out event for other class of security holders. This event is triggered automatically thus not requiring investor vote.

Other pay out events are triggered if the seller or the SPV becomes insolvent, or the seller is unable to transfer receivables to the SPV.

5. Future Receivables

Securities issued that are backed by future receivables are not called asset-backed securities because the SPV will receive the issue proceeds before any receivables are generated. Future receivable financing is an ingenious deviation from the longstanding concept that all cashflows can be securitised (Standard & Poor's, 1993b:6). Here the SPV issues bonds supported by the hope or likelihood that receivables will be generated by the originator which will immediately be assigned to it.

Conventional asset-backed securities are supported by receivables that actually exist or will be generated on a predetermined date. All parties to the transaction can calculate the value of the receivables because they have or will in the imminent future materialise into cashflows. Future receivables are, however, distinct because the parties have no idea of the receivables, their value and when they will eventually materialise into cashflows.

The first reported future receivable securitisation was carried out on behalf of Mr David Bowie who securitised his future royalty payments – this transaction created a new mould for securitisation transactions (Standard & Poor's, 1993b: 8). The performance of a future receivables transaction depends on the risk of generating future receivables, the business risk of the entity originating the receivables and finally, the structure and legal risks of the whole operation.

How a future receivable transaction works:

1. Originator and the banker will setup a SPV.
2. Directors/trustees of the SPV and the originator sign a contract in which the originator promises to generate receivables and assign them immediately to the SPV.
3. SPV issues securities backed by this contract and passes on the proceeds to the originator.
4. Originator will generate and convey receivables to the SPV.

The originator must produce goods or services which will be bought in a demanding market. In other words, the goods or services should be essentials and essential to the economy and paid for in a manner which does not cause cashflow disruptions. The originator should be financially stable and possess the ability to generate receivables during a financially unfit period.

The rating agency will examine various collected data including industry trends, asset quality, sources of liquidity, company structure, capital adequacy and special risks such as mergers and potential acquisitions (Standard & Poor's, 1993b: 11-13). An assessment of cross-border risks are essential in a transaction involving the originator based in a foreign country. Cross-border risks are classified into general types, namely, currency transfer risk and political risk.

Currency transfer risk addresses the ability and willingness of a nation's central bank to make available foreign currency to its nation's borrowers so that they can repay their debt in the appropriate currency. It is essential that a nation can generate foreign exchange to allow borrowers to comply with their obligations. To minimise currency transfer risk financiers are now making increasing use of offshore vehicles. Where the SPV is setup in the originator's own country then currency transfer risk is at its extreme if the central bank cannot allow the foreign currency needed by the SPV to repay investors available. However, these structures may not be exchange control proof. Some exchange control regulations may require that exporters bring in their foreign currency earnings from export sales back into the country. Therefore, it is essential that currency transfer regulation or guidelines and exchange control regulations are inspected closely in order to estimate the risks and determine effective methods of minimising or eliminating the risks.

Political risk addresses government actions or specific events which impair the flow of goods or services or the cashflows of the contracts. Thus, it is important to closely examine a nation's foreign trade policy and economy to estimate the scale of risk or potential risk, even if the cashflows do not pass through the country. Other harmful actions that can impact on the transaction are export restrictions, environmental regulations and trade quotas.

As said earlier, future receivables are those which will materialise from contracts between the originator and the SPV. Therefore, the rating agency will analyse the contract before using the appropriate criteria to address the risks of the assets behind the future receivables.

CHAPTER 4 LEGAL CONSIDERATIONS FOR THE ORIGINATOR

1. INTRODUCTION

This chapter of the work will unfold the law and regulation applicable to the actions of the originator in a typical securitisation. To date, the majority of originators who have participated in a securitisation structure have done so because they needed to remove, for various reasons, risk-embedded assets from their balance sheets. To effectively achieve removal, a transfer structured as a *true sale* was imperative (Kothari, 1999: 22). True sale is jargon created by practitioners to describe 'a sale at arm's length in which the transferor transfers either a legal or an equitable title to the assets to the transferee' (Kravitt, 1996: 91).

As stated earlier, a receivable is a contractual right to a sum of money that derives from a contractual arrangement. In practice, there exist three types of receivables, that is, three types of contractual rights to a sum of money. The first type of receivable is one that presently exists. Here the originator has performed its obligation under the contractual arrangement and anticipates the co-party (the obligor) to perform its obligation. The originator can assign this existing ascertained contractual right without difficulty and uncertainty. The second type of receivable derives from a revolving borrowing facility in which the co-party borrows, repays and reborrows. This type of receivable mirrors a credit card receivable, in that, the card user will use the credit facility, repay the debt and re-use the credit facility. The originator can assign the contractual rights of these receivables if and when they arise. The third type of receivable is that which will come into existence and ascertainment at a future date.

Thankfully, the method for transferring pools of receivables with changing natures has remained the same. There are three methods established by English law which have traditionally been used to transfer contractual rights between seller and buyer, namely, *assignment*, *sub-participation* and *novation*.

2. TRANSFER OF RECEIVABLES

For purposes of securitisation transferring receivables by assignment is by far the most popular and effective method used by originators to achieve a *true sale* transaction. An originator can sell and assign its contractual rights to cashflows under a legal assignment that is effected under the provisions of s.136 (1) *Law of Property Act* 1925. Section 136(1) provides three conditions, which upon satisfaction, creates a legal assignment. The parties effecting a legal assignment must ensure that,

i. the assignment is *"...in writing under the hand of the assignor..."* This condition merely imposes on the parties a procedural formality that evidences their intention and obligations under the contractual arrangement.

ii. the assignment is *"...absolute..."* This condition provides that the seller must assign the complete contractual right to the cashflow and not just a part of it to the purchaser or limit the right to the cashflow with restrictions.

iii. express notice is given to the underlying debtors. This is another procedural formality created by the law of security, which enables the underlying debtors to achieve a good discharge of their debt following the assignment. However, the notice requirement is not essential since it is now become a term in a contract that parties assigning their right under an agreement do not need to give notice. This usually applies to the creditor and not the debtor.

A legal assignment is, therefore, one, which in writing absolutely transfers the whole contractual right to a cashflow, and the parties give express notice reflecting this transfer to the underlying debtors affected. In practice, some originators do not provide the underlying debtors with notice of the transfer. An assignment, which falls short of this, has validity and enforceability deriving from the principles of equity. An equitable assignment is one where the originator purposely fails to give notice of the transfer to the underlying debtors. This is usually done because the originator would not want such debtors to know about the securitisation since it wants to maintain the contractual relationship it has with its borrowers without exposing them to complicated arrangements which the originator seeks to benefit from.

Notwithstanding this motive, failing to give notice of the transfer is disadvantageous from a litigation perspective in that should the SPV wish to bring an action against the underlying borrowers it would need to join the originator as party against the borrowers. In essence, the SPV has no *locus standi* against the borrowers because there is no contract between the underlying borrowers and the SPV (Standard and Poor's, 1993i).

The term sub-participation does not have a legal meaning yet is used widely in practice. Nor does it, in law, constitute a transfer of any contractual rights to a cashflow or obligations. Sub-participation is merely transferring credit risk of a sum of money. It is an arrangement set up by the seller to raise non-recourse finance.

The seller (usually a bank) will agree with a buyer (also usually a bank) to create a contractual relationship based upon an arrangement in which the buyer deposits a sum of money equal to the value of the sought participation. In return, the seller agrees to convey an agreed proportion of funds as and when they are received from the underlying debtors of the participated credit. The arrangement creates what is called *non-recourse finance*, that is, the buyer has no recourse to the other assets of the seller, and can only be paid if the underlying debtors pay the seller. If the underlying debtor defaults, the financial impact of the default is greater on the buyer than the seller. Thus, the buyer takes a double credit risk, namely, the risk of the underlying debtor defaulting and the risk of the seller defaulting or going into insolvency or bankruptcy (Penn, Shaw and Arora, 1987).

However, for securitisation purposes sub-participation is not a useful method to transfer the receivables because the documents do not transfer any title to the receivables, which is imperative for securitisation purposes to grant a security interest to investors. Sub-participation merely transfers the credit risk in receivables.

Novation is an arrangement in which the seller, under a legally binding contract, disposes its contractual rights and obligations under its loan documentation to the buyer. The consideration passed between the buyer and seller for the sale of the contractual rights and obligations reflects the value of the outstanding debt repayable by the underlying debtor(s) and any value of the customer relationship the seller holds with those underlying debtor(s). Novation, therefore, creates an entirely new contractual relationship between the buyer and the underlying debtor. Because the seller's obligations and rights are relinquished and discharged under novation, the wording of the documents causes the buyer to replace the seller. The buyer, as a result, becomes the lender on record and enjoys the rights and remedies, which the original lender enjoyed (Penn, Shaw and Arora, 1987: 146; Kravitt, 1996: 87).

Novation is an ideal arrangement where the seller wishes to dispose off commitments to lend (particularly under a revolving credit facility) as this is not achieved under assignment or by granting a sub-participation. Conversely, the buyer also benefits from expanding its client/debtor base.

However, the practical difficulty with creating a novation is that the documentation requires the consent of all parties involved in the original credit facility. The size of the difficulty will no doubt reflect the size and complexity of the original credit facility. Further, it creates more work, expense and complication for the originator who would need to relinquish any security interest it holds in any collateral and assign this interest to the buyer.

Although novation creates the cleanest form of transfer it also presents a further complication. The seller sells *all rights and obligations* in relation to the underlying debtors to the SPV. Thus, this places strict obligations on the SPV to undertake contractual obligations which were provided by the seller. The SPV, as its name suggests, is set up to undertake minimum duties, and burdening it with additional obligations would be contrary to its purpose and more likely to affect its ability to concede bankruptcy (Standard and Poor's, 1993i: 39-41)

3. WHAT IS TRUE SALE?

The transfer of assets incorporates the need to satisfy the *true sale test*. Under the test, the transfer must be structured so that the originator relinquishes all ownership and control over the transferred assets. The relinquishment must be recognised in accordance with the governing law of the contract (subject to local law) and the applicable accounting treatment. "True sale" means 'a transfer of financial assets in which the parties state that they intend a sale and in which all of the benefits and risks commonly associated with ownership are transferred for fair value in an arm's length transaction' (Kravitt, 1996: 92). The key ingredients here are firstly, that the intentions of the parties must be clearly expressed without ambiguity. Secondly, the transaction must be for fair value and at arm's length. And finally, it must transfer only the benefits and risks which the originator carries in relation to the receivables.

Obviously, a true sale transfer can only be challenged as invalid by a court if a dispute arises. The court can make such a challenge regardless of what the lawyers, the credit rating agency or the bankers conceived or opined when constructing the transaction. The English courts, to date, have been fortunate in not witnessing litigation where a complicated securitisation transaction is dissected and examined in order to rule whether a true sale has occurred. However, Welsh *Development Agency v. Export Finance Co. Ltd.* [1992] BCC 270, CA, deals with a sale of receivables and the method of transferring those receivables. Although it is not directly related to securitisation, it demonstrates to a certain extent how an English court views sophisticated financial transactions. In the US, however, this is not the case - even a seemingly non-contentious subject like securitisation can generate litigation in a litigious society.

Although English law lacks any rulings regarding true sale transfers in securitisation we can, however, look to the US ruling in order to gain some familiarity with how the courts view true sale under securitisation. The case law involving true sale point to three issues which have become determinative of true sale. These are intention of the parties; ownership and risk; and recourse (Kravitt, 1996: 94-99).

3.1 PARTIES' INTENTIONS

The English law position regarding securitisation and the parties' intentions still undeveloped territory. However, what can be construed from Millett LJ's language in *Orion Finance Ltd v Crown Financial Management* [1996] BCC 621 provides, to some extent, an English court's approach to the question of the parties' intentions. In Orion the question was: what were the parties thinking at the time when they entered into a complicated sale and leaseback transaction? The learned judge looked at the language of the contract to determine its underlying intention and purpose and ruled, 'the question is not what the transaction is but whether it is in truth what it purports to be'. Meaning, that if the contract claims to be a sale it should clearly create rights and obligations consistent with a sale – 'whether it in truth what it purports to be'. This short sentence implies that the approach taken by an English court is that it will look at the substance of a transaction rather than just the label given to it by the parties. Further, substance should be examined to the extent of determining whether the actual rights and obligations of the parties created by the contract are consistent with their description in the contract.

Thus, an English court, it seems, will look behind the wording used by the parties and recognise *substance over form* which means that it will give recognition and deference to the substance of the transaction rather than its form. The US position construed from the case law is very similar (Kravitt, 1996: 98). It appears that in the US a court wants to be convinced that if the parties intended a sale transaction, their acts and obligations must be consistent with those found under a sale. Such view is depicted in *Major Furniture Mart Inc. v. Castle Credit Corp. 602 F.2d 538 26 UCC Rep. Serv. 1319 (3rd Cr. 1979)*. The primary question in Major was: when is a sale not a sale but rather a secured loan?

There facts were – Major was a furniture retailer and sold items by way of a no-deposit credit facility to customers, and consequently built up a pot of receivables. In order to acquire further finance it entered into a financing agreement with Castle Credit whereby Major "sold" receivables in exchange for funds. The transfer agreement was ambiguously drafted and contained terms which caused the court to look closely at the transfer. These terms stipulated that all accounts sold shall be with full recourse against Major, and Major was required to warrant the full performance of each account sold to Castle. Further the accounts were sold at a discounted rate. Major decided to sue for the excess held by Castle claiming that the transfer was not a sale but a loan and by virtue of §.9-502 Pennsylvania Uniform Commercial Code – 'a secured party must account to the debtor for any surplus, the debtor is not entitled to any surplus where there was a sale of accounts unless otherwise stated in the agreement'. In order for Major to succeed it needed to show that the transfer was in fact a loan and not a sale.

The court looked closely at the transaction and the business activities of the parties. It held, without much elaboration, 'courts will not be controlled by the nomenclature that parties apply to their relationship'. Some commentators have interpreted this to mean that a court will look beyond the wording used in the transfer contract by examining the business activities, objections and the relationship between the parties (Kothari, 1999; Kravitt, 1996). It is true, argues Kravitt, that ambiguous wording can be used to disguise the true intentions of parties but in the US it seems a court will reject the use of simple language like 'sale and purchase' to indicate the intention of true sale (Kravitt, 1996: 97). Lawyers drafting transfer contracts are now expected, following the decision in Major, to incorporate elaborate wording which clearly demonstrates the parties' intentions. Wording such as 'sale and purchase' is now replaced with 'assigns, sets over and transfers all rights, title and interest' – language that was suggested in *Re. Golden Plan of California Inc.* 829 F.2d 705 (9th Cir. 1986), another case that briefly touched upon the issue of parties' intentions. It seems that such wording defines and describes the parties' rights and obligations in respect of true sale. This way the sale of the assets is effective against the originator, its creditors, its regulator, and its liquidator/receiver and enforceable against the underlying obligors, if worded correctly.

3.2 OWNERSHIP AND RISK

The clear passing of ownership and risk is another determinative factor of true sale. Under English law, both ownership and risk passes if a transfer complies with s.136 *Law of Property Act* 1925 which passes *all legal rights, risks and remedies* respecting the receivables to the transferee. It further, gives the transferee authority to discharge the debt without the aid of the transferor. Once such receivables have been assigned pursuant to s. 136, the purchaser then registers its interest by filing a registration statement and/or a registration with HM Land Registry (in the case of mortgages).

Typically, the originator does not give the required notice under s. 136 to the underlying debtors since such a requirement involves additional administration and costs. Thus, the transfer of the receivables does not strictly comply with s. 136 and as such the transfer is accomplished by an equitable assignment. In such a case, the SPV generally takes actual or constructive possession of the documents evidencing title for each receivable and an irrevocable power of attorney from the originator enabling it to perfect legal transfers if necessary.

The weakness of transferring receivables by an equitable assignment is that it presents priority problems between competing assignments. Priority between competing assignment is determined by the order in which notice of the assignment is given to the underlying debtor, not the order of the assignments themselves, save for where the later assignee is aware of the earlier assignment at the time that it entered into the later assignment (Goode, 2003). Thus, until notice is given, an assignment is vulnerable in terms of priority. However, in practice, language is built into the transfer agreement in form of representations and warranties given by the originator with the effect that the receivables being transferred are owned by it on the date of the assignment, and that it has not granted to any other party a security interest in such receivables. In his way, the SPV is protected against any third party claiming an interest in the receivables, and more importantly, any security interest that ranks ahead of the SPV's interest.

Conversely, in the US determining the effective transfer of ownership and risk in receivables is a state law question, and in the US assignments can be either legal or equitable depending on whether notice has been given to the underlying debtors. For the same reason as that in the UK, originators do not give such notice, and passing of ownership and risk in the receivables is evidenced by filing a registration statement pursuant to Article 9 of the *Uniform Commercial Code*. Further, priority problems are avoided through the giving of representations and warranties.

Without an effective transfer of ownership and risk significant effects can surface which can affect the SPV and consequently the investors. Note, however, that the SPV and the investors can only be affected should the originator face financial difficulty. Where there is no evidence of an effective transfer of ownership and risk in the transfer agreement, it is possible that such transaction (should a dispute arise) can be interpreted as a granting of finance secured on the receivables, in other words, 'recharacterised as security for the purposes of security and bankruptcy law' (Wood, 5-3). Accordingly, the originator and the issuer establish a debtor and creditor relationship, respectively.

Because a mortgage or a charge of the receivables confers no ownership to the SPV, the originator remains the owner of the receivables, and such receivables form part of its bankruptcy estate. Furthermore, if the originator becomes bankrupt, assuming that the SPV has registered and perfected its security interest, it will only suffer a delay in the conveying of cashflows received by the originator from the underlying debtors. If the SPV holds mortgaged receivables then the security interest will convert into ownership after following the security enforcement procedures. However, if it holds charged receivables that are unregistered then the SPV is classed as an unsecured creditor and will be paid according to the liquidator's asset distribution percentage.

Thus, it is important that the language of the transfer agreement clearly sets out the intentions of the parties. If the transfer is a sale then the wording should be redolent of a sale. Although the courts, generally, will not interfere with or rewrite the transaction, they will, however, intervene if the wording of the transfer appears inconsistent with the actions of the parties (Kravitt, 1996: 98). For example, if the wording suggests a sale but the originator retains a right to repurchase the receivables, under mortgage law this arrangement constitutes an equity of redemption of mortgaged property. Having said that, it is common for the originator to repurchase any remaining receivables after the life of the securities but the repurchase amount must be limited to a minimum.

Another example where parties claim to have documented a sale but the arrangement suggests a mortgage occurs where the originator extracts excess profit from the transaction. It is common for the originator to extract the profit made by the SPV in a manner disguised as servicing fees. However, this arrangement also suggests, in the absence of true sale language, that the originator is taking back the excess of the mortgaged property over the loan. If the transaction is, in fact, a true sale then the SPV can rightly keep the profit derived from the purchased property. Further, the originator can effectively transfer the credit risk to the SPV under true sale language. This is not the case if the arrangement is or is later recharacterised as a mortgage or a charge granted in exchange for a loan.

Case law determining the passing of ownership and risk in receivables is, regrettably, thin. As stated earlier, English courts have not ruled on any transactions where the subject matter is the transfer or purported transfer of a pool of receivables under a securitisation. The US has a very short list of such cases which have indirectly touched upon the effective transfer of ownership and risk when examining the issue of the parties' intentions. For example, the case of *Octagon Gas Systems Inc. v. Rimmer* 995 F.2d 948 (10th Cir. 1993) highlighted that ownership and risk passes if the parties intended such act (Elmgren, 1995; Kravitt, 1996: 111).

3.3 RECOURSE

The essence of transferring under a true sale contract is to assign ownership, risks and benefits to the SPV. It can be the case that a pool is transferred using true sale language but the originator agrees, directly or indirectly, to compensate the SPV should any receivables fail to materialise. This agreement to compensate may either be in the transfer contract or be disguised by action. The rating agency is aware of such compensatory provisions existing in a typical securitisation. However, it views such provisions as beneficial since they protect the SPV against non paying receivables (Standard and Poor's, 1993i). But from a legal prospective, particularly in the US, such recourse provisions are viewed as contrary to what true sale should achieve (Kravitt, 1996: 114).

The English law position with regards to recourse and true sale is still unexplored territory, although in *Metropolitan Toronto Police Widows and Orphans Fund v. Telus Communications Inc.* [2003] O.J. No. 128, the first Canadian case that dealt with true sale in Canada, the court observed that 'in both British and Canadian authorities it has been held that even full recourse is not incompatible with the concept of legal sale' without mentioning which English case it replied on to make such statement.

The English approach to recourse provisions, generally, stems from the doctrine of substantial performance. Assume the originator transfers a pool of receivables to the SPV. At the time of transfer the originator reasonably believes such receivables would materialise. Now, assume that a small fraction of those receivables fail to materialise because the underlying obligors fail to make payments. The SPV can bring a claim against the originator for breach of contract based on failed performance. However, the SPV would need to show that the small amount of non paying receivables is sufficient to rule the transfer a breach of contract – in other words does the *doctrine of substantial performance* apply to the breach? The doctrine is triggered when the breach relates to a breach of warranty (Standard and Poor's, 1993i). The originator when transferring the pool of receivables warrants that the receivables will pay thus, a breach of such warranty triggers the doctrine.

But whether the SPV is allowed to treat the whole transfer as a breach depends on the how much loss the breach of warranty has caused. For example, in *H. Dakin Co. Ltd. v. Lee*, CA (1916), the claimant builder agreed to carry out repair work on the defendant's house, and the completed work departed from the specifications in three minor respects which could be remedied at a small cost. The Court of Appeal held that the breach of warranty did not amount to a complete breach of the contract and awarded judgement for the plaintiff, subject to a deduction equal to the cost of remedying the defects. In contrast, in *Bolton v. Mahadeva,* CA (1972)*,* the claimant agreed to install a central heating system in the defendant's house for £560. The system was defective and gave off noxious fumes and the house failed to heat adequately. The cost to remedy this defect was £174. The Court of Appeal held that there had not been substantial performance on part of the claimant and thus, was not permitted to recover the cost of the work. It seems that the SPV must show that the breach of warranty affected the originator's performance substantially. In other words, did the small amount of defaulting receivables amount to concluding that the originator failed to perform substantially under the contract?

The amount to remedy the breach of warranty is an indication as to the answer. Where the cost of remedying is nominal and does not affect the heart of the contract then under the doctrine of substantial performance the SPV should be compensated for the small loss but the contract will remain effective.

However, the position in the US regarding recourse provisions is somewhat different. The US view is depicted in *Major's* case (discussed earlier). We have already seen how in *Major* a court views the language used by parties when transferring receivable and how it needs to be convinced that the parties must intend a transfer. The primary question in *Major's* was when is a sale not a sale but rather a secured loan, but court also dealt with the issue of recourse and the recourse provisions in the agreement, and held that such provisions were contrary to those found in a sale and purchase contract which aims to transfer risks and benefits.

Regardless of how the parties dress up the contract such recourse provisions are key to determining whether a transfer is nothing more than a loan granted in exchange for receivables (Kravitt, 1996). A close examination of the court's reasoning in Major spells out why it may have recharacterised the purported sale transaction as a loan. True sale is achieved when all risks and benefits are actually transferred. In *Major* a contractual term clearly provided that there were recourse provisions – provisions which the court perhaps thought were excessive in order to satisfy true sale. The court, however, failed to indicate to what extent it saw the recourse provisions as being excessive and moreover, failed to indicate or set precedent as to what level of recourse amounts to excessive recourse – was the court prepared to accept recourse provisions which were not full recourse against Major?

The academic reaction to *Major* is nicely summed by Kravitt (1996) and further explored by Pantaleo et al (1996). These academics looked at recourse provisions found in typical transfer agreements against the ruling in *Major*. Kravitt argues that a key element to finding that a sale took place, as opposed to a loan, is that the purported seller provide no recourse or such recourse is very limited. Recourse has been analytically divided into four general categories: recourse provided for uncollectibility; recourse to provide a contracted rate of return; recourse for yield protection; and recourse for representations and warranties no relating to the credit quality of the receivables. Recourse that falls within the first two categories is called *economic recourse*. Economic recourse is explored by Pantaleo et al (1996: 170-171), who correctly state that one distinguishing characteristic between true sale and secured lending is the level of recourse that is permitted against the seller. Under true sale the buyer may have recourse against the seller for *collections risk*, or put another way, the buyer can seek compensation from the seller up to an amount that is the difference between the market value (or purchase price) of the receivables and what was actually received by the buyer. This kind of recourse, they state, is compatible with true sale since it stems from first principles of contract law and the freedom of the seller to give a warranty to bolster the quality of the receivables. In effect, the seller warrants that the pool of receivables will perform in a particular fashion, and if it does not, the seller will compensate the buyer to the extent of putting the buyer in the position it would have been in had the pool performed as expected. Put another way, 'recourse for collectibility merely improves the quality of the asset transferred … the purchaser with recourse cannot do better economically than the purchaser without recourse if the asset performs in accordance with its terms' (Pantaleo et al, 1996: 171).

Thus, assume A sells B a pool of 100 mortgages, each having a life of 10 years and provides a stable yield at 5% p.a. Now assume that both parties have made assumptions that during the first 3 years the pool will lose 2 mortgages each year through obligor default. At the beginning of year 4, the pool will contain 94. Collections risk is the 6 mortgages lost through obligor default, that is, the loss sustained by the buyer through uncollectibility. In practice, the seller will replace the 6 defaulted mortgages with mortgages that provide a stream of cashflow which, when injected into the pool, will put the pool in the position it would have been in had the default not occurred. This replacing of defaulted mortgages is defined by Pantaleo, et al, as "collectibility recourse".

If the level of recourse provided by the seller is in excess of this, then there is a risk that such excessive recourse may be interpreted as *economic recourse*, recourse that is said to be incompatible with true sale (Pantaleo et al, 1996: 171). Economic recourse, in simple terms, is a payment (or a series of payments) made by the seller to the buyer that is in addition to, or outside of, compensating against *collections risk*. It is important to note that economic recourse will only become an issue if the transaction in question contains other characteristics that suggest it is, in fact, a loan transaction. For example, a court is likely to look at the passing of ownership and risk, and will certainly look to whether the intention, words and actions of the parties suggest that the buyer has become the owner of the transferred assets. It will also consider the scenario of what happens if the pool of mortgages defaults, and who suffers the loss.

Thus, it seems that in the US recourse provisions which are "excessive" or indicative of *economic recourse* are interpreted as incompatible with true sale, meaning that a transfer agreement with such provision would not transfer ownership and risk effectively; whereas, in Canada, in *Metropolitan Toronto Police Widows and Orphans Fund v. Telus Communications Inc.* [2003] O.J. No. 128, it has been held that full recourse is not incompatible with a concept of a legal sale. If Canada witnesses another case involving true sale it would be interesting to learn exactly what is meant by "full recourse" and whether this includes *economic recourse*. Additionally, if an English court is faced with the issue of true sale it would be interesting to learn whether it acknowledges and incorporates into its reasoning the US concept of *economic recourse*.

4. TRUE SALE SOLUTIONS

Judicial analysis of true sale based on black letter law and applying discretion in order gain a result (Pantaleo et al, 1996). The author believes it is this discretion that needs to be controlled by drafting certain guidance so that future judicial understanding of true sale truly reflects what true sale is in essence and the academics' view. If discretion is controlled and allowed to be undertaken within defined parameters and in accordance with clear guidance this inevitably will have a positive effect on eliminating inconsistent judicial evaluations of true sale transactions.

Two legal commentators, Professors Aicher and Fellerhoff (1991) suggest a solution for judges when dealing with the true sale issue which, in the author's view, seems rather limited. They discuss an analytical approach that focuses on whether the purchaser paid the 'reasonable equivalent of fair market price for the assets' (1991: 3). They contend that the courts should seek to answer the following question: 'what would an informed and willing buyer pay a willing seller for a transfer of the entire bundle of risks and benefits embodied in the cash flow represented by the [accounts]?' (1991: 3). They correctly add that a proper determination of this question will necessarily involve a consideration of recourse, both indirect and direct, and the effect recourse has on the purchase price. Aicher and Fellerhoff further add that, '[if] the effective price paid (accounting for all recourse…) reasonably approximates what a willing buyer would pay a willing seller, the court should not decide that such recourse devices require characterization of the transaction as a loan (1991: 3). Kravitt (1996: 117-119) acknowledges that the purchase price paid for a pool of receivables needs to be reasonable and of fair value but argues that recourse provisions should be considered in isolation of what constitutes as fair value. He is silent as to whether such consideration is to be undertaken by a court. However, recourse provisions are not part of the purchase price notwithstanding that the purchase price is somewhat calculated with recourse in mind. Pantaleo et al also discuss recourse provisions and state that recourse should be considered by a court where their consideration is necessary to determine true sale and whether the purchase price paid is based on *economic recourse*. Where economic recourse exists then the court can rightly recharacterised the transaction as a loan (1996: 172).

Unfortunately, the solution proposed by Aicher and Fellerhoff is questionable and is limited to suggesting that dealing with the question of recourse alone will eliminate inconsistent judicial evaluations of true sale. Aicher and Fellerhoff mention a "reasonable value" test, suggesting that a court's determination of what is "reasonable" should take into consideration any recourse provisions or guarantees, but they fail to mention what type and amount of recourse is permissible in a true sale transaction.

A close analysis of their solution reveals the following – a court should characterise a receivable transfer as a "true sale" when a reasonable purchase price is paid; "*reasonable*" they define as what a willing buyer would pay a willing seller taking into account all recourse; thus, any price is reasonable. However, Aicher and Fellerhoff fail to define the limits of permissible recourse and this omission may invite judges to conduct a balancing test to determine the acceptable amount of recourse in a true sale transaction. Thus, allowing judges to exercise discretion. Moreover, their proposed solution requires judges to perform the difficult task of assigning value to recourse.

Furthermore, Aicher and Fellerhoff state, 'the presence of some direct recourse or a retained interest by the seller in excess collections…is still consistent with a true sale' (1991: 3). This, in the absence of elaboration, is misleading. It is true that a limited amount of recourse may exist so as to still achieve a "true sale". However, the second part 'a retained interest by the seller in excess of collections…is still consistent with true sale' is wholly inaccurate. Section 9-502 of the *Uniform Commercial Code* implies that a retained interest in excess collections is indicative of a created security interest. More importantly, §.9-502(2) provides that,

> "… [*where] a security agreement secures indebtedness, the secured party must account to the debtor for any surplus, and unless otherwise agreed, the debtor is liable for any deficiency*."

This provision suggests that a seller's right to surplus collections accrued on transferred receivables is indicative of a security interest and not a "true sale". Furthermore, in *Major* the court held that holding a retained interest by a seller/debtor connotes the creation of a security interest in apposite to an absolute assignment**.** In *Re Evergreen Valley Resort 23 B.R. 659, 661 (Bankr. D. Me. 1982)* the court held that '*holding a security interest is indicated when the sellers retain a right to a deficiency or surplus collection*' (pg. 663). Unfortunately, Aicher and Fellerhoff's solution of just dealing with the question of recourse alone in order to eliminate inconsistent evaluations of recourse does not provide the clarity and consistency needed in a solution.

Another academic Professor Bjork (1997: 122) discusses an alternative solution to that proposed by Aicher and Fellerhoff. Bjork proposes a two step analysis which argues would assist courts in accurately characterising a transaction. Firstly, he states that mathematical formulas should be used to determine fair value of the receivables. Once a fair price has been established the court should then look at the relationship between the originator and the SPV in order to ascertain whether there is a 'separateness of entities'. If it can be shown that the two entities are separate and that receivables have been transferred at market price then this indicates sufficient evidence of a true sale. This is true to a certain extent in that showing the separateness of the two entities can assist in showing a legitimate and arm's length sale. However, Bjork's solution fails to consider the effect of recourse provisions and other factors which can indicate against true sale.

While solutions like the one proposed by Aicher and Fellerhoff and Bjork strive to establish judicial consistency in transactional characterisation they also fail to limit the discretion of the courts in characterising such transactions.

4.1 AN ALTERNATIVE SOLUTION

The author will now discuss an alternative solution which it believes goes further than the solutions of Aicher and Fellerhoff and Bjork. The author acknowledges the solution of Bjork and incorporates it to the extent that a fair value of the pool should be established and shown in addition to showing the separateness of the originator and the SPV – but now goes further.

Under a secured lending the SPV will raise funds from investors by representing that it intends to acquire a security interest in a pool of receivables. The funds raised are then given as a loan to the originator in exchange for a security interest in “risk free” receivables. The onus is on the originator to ensure that the receivables isolated for the SPV produce the intended income and that income is passed on to the SPV as repayments. The loan agreement will govern the amount and frequency of repayments.

Contrast this with a true sale – the SPV raises funds from the investors by representing that it intends to purchase a pool of receivables. The originator transfers the pool in exchange for the raising of funds. The originator retains no interest or risk in the pool. A reliable mechanism is put in place which conveys the income from the pool to the SPV. Note the disparity that under a true sale transaction, the onus is not on the originator to ensure that income is passed on to the SPV. This in the author’s view is an indication of true sale – looking at on whom is the onus to ensure the SPV receives payments from the underlying debtors.

Another problem is that the pool stops producing income because the underlying debtors default. The SPV has a limited amount of recourse – <5% – usually agreed with the aid of the credit rating agency to deal with defaults. The originator can replace these defaulting receivables. But what happens if the defaulting amount is in excess of the agreed and acceptable amount? In practice, the SPV will have a cushion of receivables (in addition to insurance policies and other credit enhancements) which will absorb the loss of the defaulting receivables. Now assume that the originator fails to make the repayments under a secured lending, or if the transferred receivables under a true sale are not producing the intended income resulting in a loss in excess of any cover. What happens? This essentially is the question in relation to recourse. Another method of testing a transaction for true sale characteristics is to ask who covers the loss of a pool in excess of the cover provided by credit enhancement facilities? If the answer is the originator then this suggests that the transaction is not a true sale – the originator has not transferred all risks associated with the receivables.

Another determinative factor is to analyse the whole securitisation structure before isolating and studying the transfer contract between the originator and the SPV. Before this is discussed further it is necessary to compare securitisation with another method of selling debt – factoring. Under a factoring arrangement the debt is sold to the buyer in exchange for an amount which is less than the market value of the debt. The buyer’s profit is the amount recovered less the price paid. The buyer would have sufficient funds in place in order to purchase the debt. Contrast this with securitisation – where debt is sold or pledged in exchange for funds which firstly, reflect fair value and secondly, are not in the possession of the buyer. It can be safely believed that securitisation evolved from factoring – the idea of selling debt. But securitisation differs in two respects – (i) the assets can be pledged in exchange for a loan and (ii) the buyer cannot purchase any right in the receivables without borrowing from investors. In essence, the buyer is not a trading company with its own two-sided balance sheet – credit and debit balances. The SPV is created to become a creditor only with a pool of receivables as assets. Any profit made between the assets and liability is used to maintain the whole arrangement and purchase additional assets only from the originator.

When determining true sale the whole structure should be analysed first and this should spark an analysis of the SPV – why is the SPV set up? Who owns and operates it? Is it a trading company? Does it have the ability to trade? What is on its balance sheet? Who are its creditors and debtors? How did it get the funds to purchase the rights in the receivables? Does it have the ability to raise funds from investors? Is it a bank trading to lend funds? How long is its life as a company? Such an investigation will reveal how and why the SPV is in the whole securitisation structure. Once this picture has been formed only then should the transfer contract be isolated and analysed to determine true sale. Thus, a court will understand that the SPV is merely a legal and commercial vehicle created to assist the originator to raise funds.

The SPV's incorporation documents will state if it has the ability to lend money – if it does then this hints that the originator created the structure to acquire funds as a loan from the SPV in exchange for a security interest. If the documents state that the SPV has no ability to lend – it should not create a debtor – then this hints true sale in that the SPV only has the ability to borrow from investors and not to acquire debtors which can upset its bankruptcy status. If the SPV has the ability to create debtors then this exposes it to potential financial difficulty in excess of the potential financial difficulty it can have in relation to its creditors. The SPV is not set up to increase its chances of getting itself into a financial mess nor create complicated accounting by trading and acquiring debtors and creditors.

The author believes that this alternative solution is more workable and will go some way to assist courts in correctly determining the character of a transaction. To recap –

- analyse the whole structure
- investigate the separateness of the originator and the SPV
- investigate the SPV

- ascertain the market value of the receivables
- closely read the transfer contract
- whose duty is it to ensure income passes to the SPV?
- who bears the risk in excess of all credit enhancement?

This discussion aimed to show that the courts may be inadequately equipped to decide securitisation issues. The author discussed how the US litigation was decided in absence of clear judicial understanding of securitisation – maybe it was the fault of lawyers who failed to present securitisation correctly to the court. Hopefully with more guidance a court will have a better understanding of securitisation and decide its issues correctly and of equal importance such guidance can assist in the correct construction of securitisation structures.

5. ARM'S LENGTH

Another significant consideration for the originator when transferring the assets is to ensure that the transaction is not nullified on the grounds that it constitutes a sham. As already mentioned, the contract language needs to be consistent with both the intentions and actions of the parties involved. Further, the originator needs to ensure that the contract governing the sale of the assets is made in good faith and for valuable consideration.

1. What is market value?

Market value is the value assigned to a pool of receivables which can assist in determining whether the pool has been transferred to the SPV for an amount which does not indicate an undervalue. Calculating market value is usually undertaken by specialist accountants with the assistance of the credit rating agency (Standard and Poor's, 1993i). Without complicating the discussion the author will now demonstrate such a calculation.

There are three key components which form the market valuation of a pool of receivables – the expected return; risk of default and costs. The expected return is the amount the pool will generate during its life. This amount is a speculative amount based upon past performance data collected by the credit rating agency and balancing it as accurately as possible with the quality and quantity of the SPV's pool. The risk of default is expressed as a percentage to reflect an amount that potentially will not produce income due to default. This percentage again is based upon past performance data collected by the credit rating agency. Costs reflect the amount of total costs expended in the transaction - legal costs, administrative costs etc.

The expected return shall be designated “ER”; risk of default “RD” and costs “C”. Now consider this formula:

ER – C = DER (discounted expected return)

DER x RD = QRD (quantified risk of default)

DER – QRD = market value

Assume the SPV has a pool of receivables with an expected return of £15,000,000. Costs amounted to £250,000 and the credit rating agency stated that the risk of default is 10%. Thus,

£15,000,000 – £250,000 = £14,750,000 DER

£14,750,000 x .10 = £1,500,000 QRD

£14,750,000 – £1,500,000 = **£13,250,000** market value

Note that this calculation omits any recourse since recourse in excess of what the credit rating agency declares as acceptable is an indication that the transaction may be characterised as a loan for security. However, calculating market value can assist in determining excessive recourse. Assume that the SPV has a pool with a market value of £13,250,000. Then look at what facilities are in place to cover loss – how much cushion does the SPV have? Then look at the recourse provisions in the transfer contract to ascertain how much cushion is provided by the originator. If the cushion provided by the originator is unreasonably in excess of the quantified risk of default then this can be viewed as excessive recourse. Thus, in the example above, if the recourse provided by the originator is unreasonably in excess of £1,500,000 then a court can rightly question the recourse provisions – has the originator transferred all risk associated with the pool?

It is common to find, in practice, a contract made between the originator and the SPV involving receivables sold at a discount. The granting of a discount is justified by the quality of the receivables pool. Some receivables will not materialise as expected and a typical pool will contain such receivables. A discount is offered by the originator that reflects the size of the defaulting receivables in excess of the expected default rate.

The size of the discount granted by the originator needs to be cautiously measured against the market value of the pool. A too large discount can easily be interpreted as a transaction at an undervalue and nullified as a result. Further, such discount should not be disguised as recourse excessive recourse.

A transaction at an undervalue can occur in numerous scenarios. However, in the context of securitisation, a transaction which is legally binding at the time of making can be nullified if the originator transfers receivables to the SPV for no consideration or where the originator sells receivables for consideration that is significantly less than the reasonable market price (excluding any discount allocated that reflects the overall quality of the pool).

2. Contractual prohibitions

The originator, unlike the SPV, is trading entity with an established business operation. It will be a party in a number of commercial contracts with either lenders or other commercial entities. Usually the originator will have outstanding borrowing on its balance sheet. Such borrowing will be tied to a lending agreement which inevitably will have anti-asset-disposal; asset-stripping or negative pledge clauses to protect the lender who has given funds to the originator (Penn, Shea and Arora, 1987: 111). This type of clause comes into effect depending on how the originator gains funds from the SPV in exchange for the receivables.

If the originator decides to pledge the receivables as security in exchange for a loan then the negative pledge clause takes effect. In essence, it protects an existing lender against an event where the originator isolates assets and pledges them as security for a loan. A typical negative pledge clause will provide (Penn, Shea and Arora, 1987: 111):

> 'The Borrower will not create or permit to subsist any mortgage, charge, lien, pledge or other security interest on or over any of its present or future assets unless all the borrower's obligations under this Agreement either:
>
> > (a) share (to the satisfaction of the lender) the security afforded by such mortgage, charge, lien, pledge, or other security interest, equally and rateably with the loan, debt, guarantee or other obligation secured thereby, or
> >
> > (b) receive (to the satisfaction of the lender) the benefit of either a mortgage, charge, lien, pledge or other security interest, on other assets or revenues of the Borrower which the lender judges to be equivalent to that granted to such loan, debt, guarantee or other obligation.'

Although the clause seems restrictive there are usually exceptions drafted which allow the originator to borrow further funds from other lenders. Commonly, the originator is expected to seek permission from an existing lender if further borrowing is intended. Whether such permission is granted depends on negotiations that favour the existing lender's interests. Note that there is another clause popular in lending agreements called the *pari passu* clause which seeks to protect the security interests of unsecured lenders where the originator borrowers unsecured debt. However, in the context of securitisation this is not appropriate since the originator will seek to give a secured interest to the SPV and not a unsecured interest.

Anti-asset-disposal or asset-stripping clauses take effect when the originator transfers assets under a "true sale" contract. As already mentioned, the originator will have existing borrowing and thus lenders will aim to protect their interest in the originator's assets. Transferring receivables can affect the originator's balance sheet even though proceeds are received. The effect depends on the actual sale – the originator may have sold the receivables at a discount in addition acceptable recourse provisions. Thus, there is a disparity on the balance sheet between the value of the receivables when held by the originator and the value received upon sale.

How much concern this would cause depends on how a lender would react to the change in the balance sheet. However, originators do securitise receivables with the intention of paying existing lenders. Thus, in such a scenario a lender may not object to the transfer of receivables. In any event the originator is expected to read closely any existing borrowing agreements and ascertain any limitations or prohibitions on transferring assets. Commonly, if assets are transferred the originator should seek the permission of any lender who has an interest in the receivables.

6. FINAL WORDS

Though it seems that the originator transfers receivables under a simple yet well drafted sale and purchase contract or security for loan contract there are important considerations which can destroy the whole contract. At the outset of the securitisation the originator will know whether it wishes to borrow the funds from the SPV or sell the receivables for cash. According to this intention the arrangement is constructed and the governing contract is drafted so that the intentions are clearly expressed.

Commonly, securitisation is intended to achieve a true sale so that receivables are sold and eliminated from the originator's balance sheet. We have seen that achieving true sale is not as easy as it seems. There are a number of important considerations for the originator which assist in determining a true sale. There is also the threat that courts may continue to recharacterise a transaction as a loan regardless of any true sale intentions and actions. Without clear guidance for judges and lawyers it seems that incorrect evaluations of transactions may continue. The author examined solutions to this problem before developing his own solution which it is hoped will assist judges and lawyers in future litigation relating to the “true sale” issue in securitisation.

Aside from true sale the originator needs to bear in mind that the transfer contract must be conducted at arm’s length so that it cannot be attacked as being a sham. The receivables should be sold at what they are realistically worth. A pool sold for less than its market value can be attacked as a sale at an undervalue. Contractual prohibitions and limitations need to be considered since they have priority over the actions of the originator when intending to sell or pledge receivables. In the main detailed legal investigation should be conducted by lawyers before offering advice in this rather complicated mechanism of raising funds.

CHAPTER 5 LEGAL CONSIDERATIONS FOR THE SPV

1. INTRODUCTION

The special purpose vehicle ("SPV") undertakes a pivotal role in a securitisation. In fact, it is the entity that actually securitises the purchased or pledged receivables to raise finance. The SPV is simply a thinly capitalised entity, structured either as a corporation or as a trust, which issues debt securities in order to raise finance. Observing a traditional securitisation structure, at first sight, gives the impression that the SPV is merely added to bridge the originator and investors so that the originator can benefit from capital market borrowing even if the originator's own credit standing fails to meet the criteria of capital market borrowing.

However, from an analytical standpoint it can be seen that the originator is not contractually linked with capital market investors but is contractually linked with the SPV only. If the contract for the sale of the receivables complies in word and action with a "true sale" criterion then the originator has merely sold receivables at their market price. However, where the agreement falls short of a "true sale" then the originator borrows not from the capital market investors but from the SPV at a rate that is fractionally higher than the rate the SPV has borrowed from the capital market investors. The difference is used for operating costs.

The SPV is created as a separate entity with its own individual legal standing and operations. It can be created as an offshoot subsidiary of the originator or, as is often recommended by counsel, as an independent legal entity controlled and operated by independent minds.

Company and trust laws of leading financial jurisdictions have developed well over time to allow the creation of several distinct types of entities (with little comparative disparities) which have the capacity of operating effectively as a SPV for the purpose of securitising receivables. But the aim of this chapter is to focus solely on the common and statutory laws of the UK and US (with a bias towards New York state law).

When structuring a securitisation each party is faced with legal considerations. In the previous chapter the legal considerations for the originator were discussed. This chapter aims to unfold the legal considerations faced by the SPV. Because of the complexity involved in securitisation and the pivotal role played by the SPV, it is imperative that the SPV is structured, controlled and operated correctly since a slight deviation can be disastrous. The legal considerations for the SPV are, in short,

- Correct form and location
- It acquires a bankruptcy remote status
- Independently controlled and operated
- Perfection of security interest in the purchased receivables

2. FORM AND LOCATION

The form and location of the SPV is the first of the legal considerations. Moreover, it lays the foundation and triggers the other legal considerations mentioned above. The investment bank acting as "sponsor" or composer of the securitisation structure and the instructed lawyers must achieve the correct form and location for the SPV so that it corresponds with the law and content of the contract, the type of security the SPV will issue, the investor base it is targeted at and the desire to minimise the imposition and amount of taxation. It would aid understanding if a working definition of "form" and "location" is provided at the outset. "Form" is used to mean the legal and physical nature of the SPV. As history depicts, a SPV has been created for the purchase and securitisation of receivables as either a corporation or as a trust with specific instructions in the trust deed respecting the operation of the trust and the assets. "Location" is used to mean the legal and physical presence of the SPV, which, again, as history depicts can be either onshore or offshore.

The law and the content of the contract, from an analytical standpoint, is a contributing factor which can determine the location of the SPV and to a lesser extent its form. A SPV can be located onshore or offshore and in practice, its location is usually perceived to be associated with the desire to minimise the imposition and amount of taxation. Again, to aid understanding, a working definition of "onshore" and "offshore" will be provided.

"Onshore" jurisdictions can be best defined as independent territories that are responsible for their own administration, legislation, forces of coercion and financial regulation and in most cases are not answerable to or dependent upon other territories. From an economic viewpoint onshore jurisdictions are classed as the developed states. "Offshore" jurisdictions can be defined as 'a centre that hosts financial activities that are separate from major regulating units (states) by geography and/or by legislation' (Hampton, 1992: 4). This separation can be a physical separation as in the case of the Cayman Islands and the UK or the separation can exist within the state, for example, in London.

It is often believed that offshore jurisdictions are synonymous with tax havens, yet a close study of offshore jurisdictions suggests that there is a blurred disparity between the two. A tax haven can be defined as a territory, which imposes no or, at best, low direct and indirect taxation compared to other territories. The disparity that exists is blurred due to the development of offshore jurisdictions in that both types of jurisdictions compete for business against each other. Many offshore centres which were once not known to be tax havens have changed legislation to appeal for more investment and capital thus, fitting the definition of a tax haven. Additionally, many known offshore centres are tax havens yet the authorities dislike the term thus, unadvertising the tax benefits.

Offshore jurisdictions, whether a tax haven or not, are governed by a derivative of one of two systems of law, namely, English law or civil law. The legislation enacted is usually rooted in or heavily influenced by the legislation of the territory which the offshore jurisdiction is dependent upon. For example, the legislation in Gibraltar is based on English law, with the principal corporate legislation being based on the *Companies Act 1929* (as amended) and Companies Ordinance 1984; Madeira is governed by civil law, its principal corporate legislation is the *Portuguese Companies Code* (Codigo das Sociedades Comerciais); Vanuatu is governed by common law and still has in place pre-independence English law; and finally, the Cayman Islands is governed by English common law and its company legislation, the *Cayman Islands' Companies Law* 1960, is based on the *Companies Act* 1948 (Hampton, 1992: 8-12).

To determine whether the SPV should be located onshore or offshore, the sponsor or composer of the structure needs to establish the governing law of the contract. A majority of financial arrangements are governed by either English or New York law, therefore, the SPV needs to be located in a jurisdiction that will legally accept the financial arrangement to which the SPV is a party. For example, assume that the originator is incorporated under and governed by New York law, the contract for the sale of the receivables is written using New York law, now, if the SPV was incorporated, say, under German law, can the SPV effectively carry out its operations without triggering a conflict of law problem or a perfection of security problem? Possibly not.

Therefore, to eliminate any potential and unnecessary problems the SPV is always located in a jurisdiction which will facilitate its operations. Additionally, the rating agency, before assigning any rating to the securities, will need comfort that the receivables have in fact passed to the SPV and that the SPV is the legal and beneficial owner of the receivables. Further, that the security interest in the receivables has been perfected and can be called upon should the originator become insolvent or the arrangement runs into difficulty and the assets need to be liquidated. The governing law of the contract in this context relates to the location as opposed to the form of the SPV since both onshore and offshore jurisdictions allow the formation of trusts and companies.

2.1 SPV AS A CORPORATION

In the main, the corporation law of popular jurisdictions is rooted in one of the following systems of law, English, US or French Civil law. Each of these systems of law facilitate the formation of a trading corporation. The local law of the jurisdiction provides the gloss which reflects the distinctive characteristic of the corporation formed under that jurisdiction.

A company formed and registered under English law can take one of two recognisable forms, limited or unlimited. In short, the disparity is as follows, an unlimited company will have members who will be held responsible and accountable for all debts of the company without any limit, whereas a limited company will have members whose responsibility and accountability is limited either by the size of shares they individually hold (s. 1(2)(a) *Companies Act* 1985) or by the personal guarantee afforded by them individually in favour of the company (s. 1(2)(b) *Companies Act* 1985). Thus, from a commercial standpoint, a limited company is a much advantageous entity and prompts praise such as 'the greatest single discovery of modern times. Even steam and electricity are less important than the limited liability company' (Butler (in Diamond, 1982: 42)).

A majority of the companies formed under English law are limited companies which further, can take one of two forms, private or public. A private company can only offer its membership or shareholding to a restricted class of investors, whereas a public company can canvass for membership or shareholding from a wider class of investor, i.e. the general public (s. 81 *Companies Act* 1985).

A SPV created specifically for securitisation, in practice, takes its initial form as a private limited company – a special purpose vehicle. It can be one that has a specific object clause in the memorandum or one that has a general "catch-all" object clause – also known as an 'off the shelf' company. After registration with the registrar it will lie dormant until a public issue of debt securities has been planned. Pursuant to s. 43 CA 1985 the private company is re-registered as a public company – this change in status is much more common than vice versa. The company must pass a special resolution that is supported by at least 75% of the votes cast. The registrar must be provided with a statutory declaration that the minimum capital requirements for public companies have been complied with and that a special resolution favouring the change in status has been passed. Pursuant to s.47 CA 1985 the registrar may accept this as sufficient evidence and issue a certificate of incorporation. Such a certificate, under s.47 (5), conclusively states the new status of the company.

Thus, a UK originator can sell or pledge receivables to a UK created private limited company and when a public offering is arranged on paper, the SPV's legal status is changed to a public limited company. However, where the originator is a non-UK entity, it still is required to set up a UK entity which then transforms itself into public limited company. An influencing factor as to the location of the SPV is the place where the securities are ultimately issued. Though securities law respecting non-alien and alien entities are similar in spirit, alien entities need to show credibility to the foreign investors. A non-alien entity will have satisfied local corporation rules and any investors will gain comfort knowing that the entity is established locally. In contrast, an alien entity issuing securities needs to convince investors that regardless of its foreign incorporation, it is a credible entity. Thus, to overcome any difficulty the SPV is established in a credible jurisdiction and can show links with the jurisdiction in which the securities are to be issued.

Both English and civil law have influenced the corporation law of the US. Save for the obvious disparities in language, terminology and interpretation, US corporation law differs from English law in some significant way (Gusset, 1998: 2-3). For example, in the US, corporations have officers as well as directors; bye-laws are often created post-incorporation; and directors can be empowered to modify bye-laws. Because of the structure of the US legal system, corporation law differs slightly from state to state. But generally, the law of the state in which the corporation has been incorporated governs the corporation and its directors and officers. Under the law of the US, a corporation can take one of the following legal forms –

- Close corporation
- General corporation
- "S" corporation
- Limited liability corporation (LLC)

A "close" corporation is created by an individual or a small group of individuals who undertake the management of the corporation's affairs. Furthermore, an individual or a small group of individuals hold the equity, that is, its stockholding. It is comparable with the private corporation incorporated in the UK.

In practice, a "close" corporation would not be an ideal vehicle which can effectively securitise receivables due to its inability to canvass and sell securities to the public.

A "general" corporation is comparable with the English public limited company thus, ideal to securitise receivables. Under New York State law (s.202 (a)(7) BCL) an incorporated SPV can issue bonds, notes and other obligations in order to raise finance. Further, the bond proceeds can be passed on to the originator as a loan if the agreement falls short of achieving true sale (s. 202 (a)(8) BCL). The "S" corporation was born after the *Tax Reform Act* 1986 and has since become a highly desirable vehicle for tax purposes. In short, any income received secures pass-through treatment if an "S" corporation election is made. This, in practice, is made on IRS form 2553. Consequently, any income is treated as though it is received by a partnership as opposed to being received by directors and officers. In other words, there is no entity level taxation imposed and the holders of the securities pay taxation at the personal rate of 28%.

The "limited liability" corporation ("LLC") is the latest advance in the evolution of business formation. Its origins are rooted in Europe and the first statute which enacted its formation was modelled on the 1892 German company law known as the German GmbH Code 1982. In 1977 Wyoming was the first state to create this type of corporation soon to be followed by all the states. The LLC combines the advantages of its alternatives, for example, a "general" corporation is subjected to double taxation, once at corporate level and again at a personal level, whereas the LLC is only taxed once at a personal level – investors pay at their personal rate. Other advantages include, no citizenship requirement – the "S" corporation restricts non-residents becoming shareholders – thus, the originator and/or those who own the equity of the SPV must be US residents which can prevent foreigners from owning a SPV in the US. Further, the LLC has no limitations on the size and number of its members, no tax penalties upon its liquidation, no limitation on ownership of other corporations and allows limited liability to all members including those who participate in management (Moody's, 1999: 3-5).

Among the reasons for the popularity of the LLC structure is the ability of the owners/members of the LLC to participate in its management without exposing themselves to the liability for its obligations. The fiduciary duties of LLC managers may be contractually specified, so it may be possible to prevent the independent director's conflict of interest situation by providing in the LLC agreement that the managers fiduciary duties are owed primarily to the investors and only secondarily to the LLC's members.

To reduce the risk of bankruptcy, the LLC agreement typically requires that the filing of a bankruptcy petition must be authorised by a unanimous vote of the board of managers of the LLC. The board of managers can be independent of the SPV's equity owner(s) and, pursuant to the express provisions of the LLC agreement, would not owe their fiduciary duties primarily to the owner. In some instances, LLC agreements contain provisions automatically adding one or more independent managers as a member, in the event of a ratings downgrade or the insolvency of the original member.

An interesting question is whether the LLC SPV survives in the bankruptcy of any owner or member – it is somewhat clear from *Re ICLNDS Notes Acquisition, LLC*, 259 B.R. 289, that LLCs are eligible as debtors under the Bankruptcy Code, but it is unclear whether a single member LLC (where one entity owns the equity of the SPV) continues to exist after the bankruptcy of its single member (Gusset, 1996: 4).

In *Re Garrison-Ashburn, L.C.,* 253 B.R. 700, a bankrupt member of a LLC claimed that a real estate transaction which had been authorised by the operating manager/member of the LLC was ineffective because his consent had not been obtained. The court concluded that since under 'the operating agreement a member could, without being in breach of the operating agreement, resign from all of his offices and committee positions and no longer actively participate in the affairs of the company', the court found that 'such a member would stand in an analogous position to the company as a shareholder to a corporation' – thus survival of a single member LLC exists beyond its sole member's bankruptcy (pg. 706).

However, the court in *Re De Luca,* 194 B.R. 79, enforced a Virginia LLC agreement that expressly provided for the dissolution of the LLC upon the bankruptcy of a member. Moreover, the court in *Re Daugherty Constr., Inc.* 188 B.R. 607*,* held that a Nebraska statute which expressly provided that a LLC automatically dissolves upon the bankruptcy of one of its members unless the remaining members vote to continue the LLC determines the life of the LLC SPV. Thus, it seems that unless the governing statute provides for the continuing existence of the LLC SPV or the LLC agreement expressly determines the life of the LLC SPV, the life of the LLC SPV ends on the bankruptcy of it single member. In conclusion, the LLC can make a good vehicle for securitising receivables in some states. The UK does not have an entity similar to the US LLC thus, avoids any of the aforementioned difficulties.

2.2 SPV AS A TRUST

The trust concerned will be one whose purpose is to purchase the receivables and pay the investors. Furthermore, the trust would be one which is workable in established legal jurisdictions. In a securitisation structure a trust enables the easy satisfaction of the true sale requirement. In the structure the originator transfers receivables to a trust which is specifically manufactured to purchase those receivables and carry out duties essential to the maintenance of the structure. Independent trustees are elected to carry out the duties with a trust manger who has overall control. Because the trust lacks capital to fund the acquisition of the receivables, it issues equity-like interest in the trust in the form of trust certificates to investors. These certificates represent an undivided fractional beneficial ownership in the underlying receivables.

In a private offering, one which is accepted by sophisticated purchasers, participation certificates are offered giving investors interest in the receivables, rather than in the trust as is the case in a public offering. The reason for eliminating the trust from the structure in a private offering is that investors are thought to be capable of dealing directly with the parties involved and in the event of a default can quite easily enforce their rights. The important distinction between private and public offerings is that in the former, the investor has a direct link with the receivables due to the interest he or she acquires in the receivables and can enforce rights without an intermediary, whereas in the latter, the investor normally has an indirect link with the receivables as he or she owns an interest in the trust only. This is because the link with the receivables is through an intermediary (normally a trustee) who is utilised by the issuer to handle the physical administration of the issue for reasons of convenience and cost effectiveness. In the event of a default the trustee will enforce rights on behalf of the investor.

In the UK, a trust established for the purpose of securitising receivables takes the form of an express trust created via a trust deed. The deed will set out the ambit of the trustee's duties and responsibilities. Either the originator or the banker can be the settlor but neither is permitted to be trustees or beneficiaries. The deed will also dictate the life of the trust and deal with reinvestment of profit. Where reinvestment is not required then the trust takes the status of a non-trading trust. Conversely, where trustees are instructed to reinvest profits or funds into the pool of receivables by purchasing additional receivables then the status is that of a trading trust which is liable for taxation on any profits. An alien originator is free to use a UK trust to facilitate a securitisation, though commonly, trusts are established in offshore jurisdictions for tax purposes.

The US has created three types of trusts, grantor, owner and master trust. A grantor trust is structured specifically so as to enable it to acquire a non-taxable status. Regulations in place ensure that the trust maintains its non-taxable status

(US Department of Treasury Regulations, s.301.7701-4). In short, they provide that the trust must not engage in a profitable business, must not be empowered to vary the terms of the investment and must only issue ownership interest based on a single class of certificates. The first of these requirements means that the trust must not hold itself out as a trading trust. Thus, it cannot be used if reinvestment in new receivables is sought. The trust must issue one class of certificates – it is prohibited by tax regulations from issuing a multiple class of securities, i.e. commercial paper and medium-term notes. However, the regulations do permit an exception in that a multiple class may be issued in the form of senior and subordinate classes as long as the originator retains the subordinate class as credit support for the trust (US Department of Treasury Regulations, s.301.7701-4(c)(2)).

A grantor trust is included when securitising instalment obligations with defined amortisation schedules and fixed final maturity dates, such as mortgages, car loans and other instalment loans. The reason for this is that the income from the receivables will flow freely and merely "pass through" the grantor trust to the investors. There is no need to reinvest income in new receivables as the securities issued and the receivables will have the same maturity dates, save for early redemption.

An owner trust will not qualify as a non-taxable trust because the trust manager is empowered to deal with the cashflows of the receivables. Instead of the income flowing from the receivables and passing through to the investor, it is withheld by the trust manager and paid according to the income demands of the investors. An owner trust will issue interests in the trust backed by receivables with different maturity dates and interest payment dates. If this were a "pass through" transaction, inevitably this would lead to a mismatching of income and payments. Since an owner trust can engage in business activity it can reinvest principal payments received from the receivables by purchasing new receivables so that the investor's interest in the trust remains at original level. The receivables are usually short term obligations, i.e. credit card receivables, which expire rapidly. As a result the trust manager ensures that the trust's pot of receivables is not exhausted. To do this the trust manager purchases new receivables and thus maintains the pot, which allows the investors a continuing interest in the trust. The interest is paid to the investors in arrears and during the "interest only" period of the securities. The originator takes the proceeds from the sale of the certificates together with the unsold ownership interest in the trust. This allows the originator to have a vested interest in the structure and an incentive to sell receivables to the trust. Interest for the originator's share of ownership is paid directly to the originator.

A master trust is used so as to give the issuer access to multiple markets simultaneously. The originator transfers receivables to a master trust which will issue more than one class of ownership certificates backed by fractional shares in a common pool of receivables. For example, 75 per cent of the pool will be used to back a medium-term issue while the remainder will be used to back a commercial paper issue. The trust manager is empowered to manage the cashflows of the structure. Reinvesting income is common as commercial paper is a short-term security. It also acts as over-collateralisation. The master trust is structured so that it is either a partnership or a vehicle generating debt for the originator for tax purposes.

A trust is thus, a flexible and useful arrangement with use as unlimited as the imagination of lawyers in taking account of the wishes of bankers and businessmen.

3. FORMATION OF THE SPV

The uniqueness of asset-backed securities derives from their structure, that is, that solely the collateral, creditworthiness and cashflows of a pool of receivables support them. Since this is the sole income generating mechanism held by the SPV, it is important that internal and external parties or their actions do not affect this mechanism.

To minimise external actions affecting the SPV's assets, rating agencies insist that the SPV is created so that firstly, it is independently owned and controlled and secondly, it holds a bankruptcy-remote status. Such a position is achieved when the SPV, after the rating agency's structural analysis, proves that it is remote from any potential threat of being consolidated with the originator and/or remote from involuntary bankruptcy which may be imposed upon it by creditors and surprisingly its debtors. Regardless of the care and detail with which the SPV is created, it is important to note that the SPV is merely bankruptcy remote and not bankruptcy proof. Note that it is against public policy to restrict an entity from voluntary bankruptcy. For example, in the UK, s.84 *Insolvency Act* 1986 allows a company, after the passing of a special resolution, to voluntarily be subjected to bankruptcy proceedings. In the US, s.101 *Chapter 11 United States Code* states that an entity is free to file or avail itself of rights under the U.S. Bankruptcy Code.

4. INDEPENDENTLY CONTROLLED AND OPERATED

Aside from the internal structuring of the SPV to minimise involuntary bankruptcy it is also important to restrict potential adverse consequences associated with its parent or affiliate. Because the SPV is created to benefit the originator, the originator will undoubtedly make a contribution to the formation of the SPV. Because there are no rules prohibiting the originator from contributing physically or financially to the formation of the SPV, there has been some guidance created by case law in the US that provides some assistance in this area.

This assistance is generally known as the "doctrine of substantive consolidation". It means 'the merger of separate entities into one action so that the assets and liabilities of both parties may be aggregated in order to effect a more equitable distribution of property among creditors' (Sargent, 1989: 1224). Thus, if the parent faces bankruptcy proceedings the SPV's assets can be used to pay its parents debts. The rating agency will insist that the SPV is not owned or operated by an entity that is far from bankruptcy remote. The rating agency as well as the courts will analyse the relationship between the SPV and its parent or disguised parent by utilising an *alter ego* approach (Standard and Poor's, 1993i: 44).

The investigation aims to seek any links between the SPV and the originator that show that they are in effect one entity and that their assets and liabilities should be combined. In the UK, there is case law which deals with the issue of consolidation. The case of *Smith, Stone & Knight v. Birmingham Corporation* [1939] 4 All ER 116, is an early case on consolidation. Although not in the context of securitisation, Atkinson J offers useful guidance:

> 'I find six points which were deemed relevant for the determination of the question: Who was really carrying on the business? In all the cases, the question was whether the company, an English company here, could be taxed in respect of all the profits made by some other company, being carried on elsewhere. The first point was: Were the profits treated as the profits of the company? – when I say "the company" I mean the parent company – secondly, were the persons conducting the business appointed by the parent company? Thirdly, was the company the head and brain of the trading venture? Fourthly, did the company govern the adventure, decide what should be done and what capital should be embarked on he venture? Fifthly, did the company make profits by its skill and direction? Sixthly, was the company in effectual and constant control,'

Where these questions can be answered in the affirmative then the SPV may be treated as a front or the "child" of the originator and can be dragged into any bankruptcy proceedings affecting the originator.

But English law in relation to consolidation goes back to the authoritative case of *Salomon v Salomon & Co Ltd* [1897] AC 22. The case established the principle that a company upon incorporation is a new and separate artificial entity.

In law, a company is a distinct entity with its own personality separate from and independent of the persons who form it, who invest money in it and who direct and manage its operations. Thus, the rights and duties of a company are not the rights and duties of its directors or members who can be hidden by a corporate veil surrounding the company. This ruling has been tested by time and came under examination in *Re Polly Peck International Plc* [1996] 1 BCLC 428. Here the SPV was set up in the Cayman Island as a thinly capitalised subsidiary of the originator – it had common directors too. However, the Court refused to treat the SPV as a mere facade and emphasised that it is legal substance rather than economic substance that should guide the court.

However, the US has witnessed a different picture regarding consolidation. A leading and illustrative case involving substantive consolidation in a bankruptcy proceeding is *Re Vecco Construction Industries, Inc* 4 B.R. Here the court in a Chapter 11 proceeding (company reorganisation in order to save it from bankruptcy) considered whether substantive consolidation of four wholly-owned subsidiaries with the parent corporation was appropriate. Although individually incorporated, the court discovered facts that indicated only a marginal separateness amongst the companies. Part of the evidence was the commingling of funds, consolidation of financial reports and accounts, disbursements and receipts paid from a single account, use of the same office space, transfer of inventory between concerns without documentation or record, and identical governing boards.

Commencing its determination of whether to order substantive consolidation, the court considered the equitable doctrine of substantive consolidation. The court stated that a determination of whether to allow consolidation should be based on the following criteria: firstly, the degree of difficulty in segregating and ascertaining individual assets and liability of the companies. Secondly, the presence of consolidated financial statements. Thirdly, the profitability of consolidation at a single physical location. Fourthly, the commingling of assets, and fifthly, the existence of parent and inter-corporate guarantees on loans and finally, the transfer of assets without formal observance of corporate formalities.

Citing the decision in *Chemical Bank New York Trust Co. v. Kheel* 369 F.2d 845 (2d Cir. 1966), the court recognised the additional consideration of 'whether the individual assets of the corporate entities were so unascertainable and hopelessly obscured as to entail substantial expense in segregating such assets and liabilities as to threaten the realization of net assets for the benefit of creditors' (pg. 407-408). Consequently, the court ruled that the subsidiaries 'were but instrumentalities of the bankrupt with no separate existence of their own' and granted the request to substantively consolidate the estates.

Also consider *Re Buckhead America Corporation* (The Days Inn Case) 161 B.R. 11 (Bankr. D. Del. 1993). The facts - Days Inn of America, Inc. ("DIA"), a motel franchiser, transferred its franchise fee receivables along with the corporate trademark and accompanying goodwill to Days Inn Receivables Funding Corp. ("issuer"). The issuer qualified under Standard & Poor's criteria as a special purpose bankruptcy-remote subsidiary and publicly issued $155 million in notes secured by the franchise fee receivables. A company memorandum, distributed upon the issuance of the notes, expressly provided that the issuer would not be consolidated with DIA in the event of DIA's insolvency. From all aspects it appeared as though the securitisation would be a success. Following the completion of the securitization transaction, DIA petitioned for relief under chapter 11 of the Bankruptcy Code. After filing DIA received a comprehensive offer for all the company's assets, including the franchise fee receivables and the corporate trademark rights. In order to reacquire the Days Inn trademark and franchise agreements and to facilitate the sale of the corporation's assets, DIA filed the solvent Issuer into bankruptcy as well. The filing of issuer was occurred despite the presence of an independent director. DIA and issuer were subsequently consolidated pursuant to an order of the bankruptcy court.

The *Days Inn* case raises a number of significant yet disturbing points (Gusset, 1996: 6; Kravitt, 1996). Firstly, the transfer of the franchise fee receivables and corporate trademark was structured as a true sale assignment. However, the lawyers involved failed to consider that a court may classify the franchise fees as accounts rather than general intangibles and failed consider the approach mentioned in *Octagon Gas Systems Inc. v. Rimmer* 995 F.2d 948 (10th Cir. 1993) (discussed in chapter 4). Secondly, a legal memorandum was issued indicating both the intent of DIA and the issuer to effectuate a true sale and more importantly not to file the issuer into bankruptcy so long as issuer was solvent. Thirdly, although an independent director sat on the board of issuer there was a requirement that all directors must vote in favour of any bankruptcy filing.

Despite the presence of several factors mitigating against consolidation, the bankruptcy court ordered substantive consolidation of the assets of issuer with the estate of DIA. The court stated that there were facts which justified the merger of the two estates without going into any detail. The court failed to recognise that the SPV was a separate entity – it failed to recognise the presence of an independent director – it failed to recognise that the *Octagon Gas* case and its failure to correctly acknowledge securitisation. Despite this the court recharacterised the transaction thereby voiding the asset transfer. This case consequently sparked the question - do courts actually understand the mechanism behind securitisation? (Gusset, 1996: 6-7).

The US government reacted to the inconsistency in judicial evaluation by proposing this amendment to s. 541 of the Bankruptcy Code –

> s. 541…" (b) Property of the estate does not include –
>
> …
>
> 5) any eligible asset (or proceeds thereof), to the extent that such eligible asset was transferred by the debtor, before the date of commencement of the case, to an eligible entity in connection with an asset-backed securitization, except to the extent that such asset (or proceeds or value thereof) may be recovered by the trustee under section 550 by virtue of avoidance under section 548(a);

The "*eligible asset*" requirement was key to avoiding recharacterisation. The proposed amendment recognised securitisation as a reason to transfer assets and went further to define such assets,

> (2) The term "eligible asset" means –
>
> (A) financial assets (including interests therein and proceeds thereof), either fixed or revolving, including residential and commercial mortgage loans, consumer receivables, trade receivables, and lease receivables, that, by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security-holders;
>
> (B) cash;
>
> (C) securities;

Another surprise was,

> (5) The term "transferred" means the debtor, under a written agreement, represented and warranted that eligible assets were sold, contributed, or otherwise conveyed with the intention of removing them from the estate of the debtor pursuant to subsection (b)(5), irrespective, without limitation of –
>
> (A) whether the debtor directly or indirectly obtained or held an interest in the issuer or in any securities issued by the issuer
>
> (B) whether the debtor had an obligation to repurchase or to service or supervise the servicing of all or any portion of such eligible assets; or
>
> (C) the characterization of such sale, contribution, or other conveyance for

tax, accounting, regulatory reporting, or other purposes.

Section 541(5)(c) was interesting since it provided that as long as a document evidencing the intentions of the parties to effect a true sale, such transaction will not be recharacterised. This proposed amendment was drafted in 2000 following lengthy snail-paced discussions and were later dropped by Congress following the financial scandal involving Enron.

A fundamental principle gleaned from case law, such as *Union Savings Bank v. Augie/Restivo Baking Co., Ltd.* 860 F.2d 515, 518 (2d Cir. 1988) suggests that substantive consolidation should be ordered when 'the affairs of the debtor are so entangled that consolidation will benefit all creditors' (pg. 524). Thus, we have seen the disparity in how the UK and US courts approach consolidation. The UK courts are reluctant to order consolidation in the absence of a sham or fraud whereas, in the US, the courts will seek out links between the SPV and the originator and order consolidation.

Case law has therefore, produced the following factors, which help to determine whether the SPV is merely a front for the originator:

1. the originator owns all or a majority of the equity in the SPV
2. the originator and the SPV share directors and officers
3. the originator financially assisted the SPV during formation
4. the originator was responsible for the SPV's incorporation.
5. the SPV has insufficient capital
6. the originator is responsible for and pays all the SPV's operational expenses
7. the SPV is commonly referred to as belonging to the originator.
8. directors and officers of the SPV take instructions from the originator

Additionally, courts from different nations/states have used slightly varied factors but generally, the analysis is alike. However, one should not assume that because circumstances of a particular structure meet these requirements the SPV would be assumed as belonging to the originator. The courts will decide consolidation on a case-by-case basis – though these requirements provide a good guidance.

To assist all parties involved in the securitisation to eliminate any potential adverse effects of substantive consolidation the SPV needs to be formed with care and detail. The rating agency will offer some guidance. In addition, a legal opinion from the SPV's legal counsel should be sought setting out exactly the SPV's position should any parent face financial difficulty – this is a pre-requisite before any indication of a rating is made (standard and Poor's, 1993i: 47). In short, the following undertakings are imperative:

- the SPV maintains separate books and records pertaining to its operations
- there is no commingling of assets, funds or accounts
- the SPV holds itself out to the public as a separate and distinct entity
- the SPV prepares its own tax returns (if relevant)
- An independent director is seated on the SPV's board
- The SPV's assets are clearly shown on its financial statements
- The SPV will not pay or guarantee the debts or obligations of its parent or affiliate and vice versa
- Any transaction between the SPV and the originator should be at arm's length
- The SPV utilises its own letterhead, telephone and operational offices

This list is, of course, not exhaustive but gives indications as to the degree of care and detail that is needed when forming the SPV. The rules are relaxed when utilising a non-trading or grantor trust as trust law protects the trust property.

5. BANKRUPTCY REMOTE

The SPV, aside from ensuring that the receivables are purchased correctly from the originator, also needs to ensure that it itself is "bankruptcy remote". This is jargon which means that the SPV is not threatened with potential bankruptcy. It achieves this status through careful construction and operation. The SPV can be made to hold a bankruptcy remote status but it can never be made bankruptcy proof. Many commentators, for example, Aicher and Fellerhoff (1991) and Gusset (1996) have concisely restated what and how such bankruptcy remote status is achieved without treading further. However, the author will now discuss bankruptcy remote by incorporating existing commentary before testing the strength and validity of such bankruptcy remote status.

It is important to note that the SPV (whether a corporation or a trust) is created solely to purchase or receive a pool of receivables from the originator or pools of receivables from a number of originators. However, this ability to contract with parties is clearly stated in its memorandum or trust documents and to facilitate the acquisition of a bankruptcy remote status, on the recommendation of the rating agency, these documents should list clearly which party(ies) the SPV can transact business with. Where the SPV is created for a "one-off" securitisation then its ability to purchase additional pools of receivables should be restricted so that it does not expand its list of creditors, which in all cases should be kept to a minimum (Standard and Poor's, 1993i: 39-41).

The documents should also include details of the activity the SPV is permitted to undertake. Since it is created for a special purpose with limited operational parameters which are dictated by the rating agency's analysis, this should be included together with all restrictions so that the SPV cannot transact business which it is not permitted to undertake. The rating agency's analysis will provide guidance as to what type of receivables should be purchased in the event that the pool is declining and the amount permitted periodically (expressed as a percentage called the purchase rate) so that the process of receiving payments and making payments advised by the rating agency is not deviated thus, cause financial and cashflow difficulty for the SPV. A securitisation structured using a pool of revolving receivables will have in the servicing agreement strict clauses relating to the additional purchasing of receivables. Revolving receivables are those with a short life expectancy, such as trade receivables, which materialise within an expected time period. A pool of revolving receivables needs to be refilled so those sufficient funds exist to pay investors (Standard and Poor's, 2000a: 5). An important consideration for the SPV when purchasing additional receivables is to ensure that the additional receivables are similar to those they are replacing in terms of financial strength and reliability. Further, it can also lay the foundation for any malpractice claim against the management company should the SPV transact unnecessary or wrongful business.

The SPV will have a list of creditors which are either created by law, (i.e. tax authority if the SPV is to pay taxation) or the regulatory authority governing its incorporation or by contract such as the management company. These creditors have been accounted for in the financial calculations and all fees have been either raised or held in reserve accounts or will emerge from the profit the SPV will make periodically. Because certain creditors were anticipated at the outset of the whole transaction, steps are taken to minimise any threat of involuntary bankruptcy that can be posed from these creditors. In practice, inherent in each document signed by each creditor and the SPV is a covenant which prohibits such creditor from exercise its right to file any involuntary bankruptcy proceedings against the SPV during the life of the securities. But such bankruptcy waivers are questionable since they restrict the rights of creditors to file a petition (Gusset, 1996:3).

A significant case in the US is *Re Kingston Square Associates* 214 B.R. 713 (Bankr. S.D.N.Y. 1997) – where a bankruptcy court held that a debtor may orchestrate an involuntary bankruptcy petition for the purpose of avoiding bankruptcy remote provisions – questioned again the judicial approach towards securitisation and more importantly questioned whether a SPV is truly bankruptcy remote.

Kingston Square involved a mortgage-backed securitisation – the parties included two trustees, eleven SPV's (all controlled by the same person, the "principal") and seven creditors (who each filed an involuntary bankruptcy petition against the SPVs). The trustees represented investors who were the beneficiaries of mortgage pass-through certificates issued by the SPVs in a securitisation transaction. The mortgage certificates entitled the beneficiaries to a stream of future payments. For the purpose of securing the (approximately) $277,000,000 the trustees spent purchasing the pass-through certificates, they took a mortgage on various properties owned by the debtors. As part of the securitisation, the debtors inserted "bankruptcy remote" provisions in their bylaws. The provisions required a unanimous vote of the directors in order to file a voluntary bankruptcy petition. In conjunction with the unanimity requirement, the provisions also called for an independent director whose purpose was, in part, to prevent the required unanimous agreement for the filing of a voluntary bankruptcy petition thereby making the likelihood of a filing virtually nonexistent.

As a result of a default on the pass-through certificates the trustees instigated foreclosure proceedings on all of the properties securing the certificates. The only way that the debtors could stop the foreclosures was to file a bankruptcy petition and availing themselves of the protections of the Bankruptcy Code's automatic stay. However, due to the bankruptcy remote provisions in the bylaws, the principal had to consider methods other than a voluntary petition to get each of the debtors into bankruptcy. Thus, the principal gathered a group of "friendly" creditors for the purpose of orchestrating an involuntary petition against each of the debtors whom he controlled.

The trustees moved for a dismissal pursuant to section 1112(b) of the *Bankruptcy Code* arguing that each of the involuntary petitions was the result of collusion and therefore filed in bad faith. They argued that the principal 'initiated, funded and identified seven friendly creditors to prosecute the involuntary petitions so each debtor could obtain improper leverage against the [trustees] by gaining access to the bankruptcy court without violating the bankruptcy restrictions in the bylaws of the various debtors' (pg. 719). On the other hand, the petitioning principal claimed that seeking bankruptcy protection was their only means to '(i) preserve any chance of recovery on their claims…before the [trustees] foreclosed on the assets of each debtor, (ii) challenge the validity of the [trustees'] claims, and (iii) find a third party to fund a plan of reorganization or purchase the properties, which would result in a greater recovery to all parties than would be obtained from the pending foreclosures' (pg. 722).

The arguments made by the principal appears to have some merit but should be viewed in light of the following – the "friendly" creditors the principal gathered for the purpose of this orchestration consisted of two trade creditors and five professional organisations (such as law firms and a consulting firm) whose overall debt was not significant enough to cause them on their own to file an involuntary petition prior to the solicitation by the principal. Furthermore, the principal paid a law firm to do the work, and several of the creditors were only willing to join in the filing of the involuntary petitions on the condition that the principal would handle all legal fees and administrative matters. One of the creditors had already written off the debt as "uncollectible" and only one of the creditors had taken any action beyond sending invoices to enforce its legal rights prior to the filing.

On this set of facts, the court correctly noted at first blush, these cases seem ripe for dismissal. However, that statement is the closest the court came to acknowledging the questionable tactics employed by the principal. Aside from the fact that the case appeared right for dismissal, the court noted that within the boundaries of well-settled principles, a bankruptcy judge has wide discretion to determine if cause exists and how ultimately to dispose of the case. Although this is true and would seemingly help to facilitate a just result, the court's opinion did not analyse the underlying motives in this type of transaction. Nor did it consider how ill-suited the case may be for judgement based on well-settled principles (Lipson, 2002: 6).

The trustees, however, relied on *Federal Deposit Insurance Corp. v. Cortez* 96 F.3d 50 (2d Cir. 1996) where the court held that a bankruptcy petition may be dismissed when a court determines that the filing was collusive because it is a fraud upon the jurisdiction of the Bankruptcy Court. The court reviewed *Cortez* and concluded, '[in] each of [those] cases, a debtor attempted to bypass a statutory or court-imposed restriction on filing a new bankruptcy case by arranging the filings of involuntary cases with friendly creditors' (cited by Lipson, 2002: 8). The primary difference between *Cortez* and *Kingston Square* is that the petitioners in *Kingston Square* were acting in concert with the debtor's principal for the purpose of circumventing the bankruptcy remote provisions whereas, *Cortez* dealt with the circumvention of statutes or court-imposed orders.

The court in *Kingston Square* acknowledged that debtor orchestration of involuntary petitions is indicative of bad faith but it held that orchestration standing alone is not enough for a bad faith dismissal based on collusion. The court declined to extend *Cortez* and did not adequately explain why. Consequently, the court allowed the petition. The *Kingston Square* transactions were specifically structured to avoid bankruptcy but the court allowed the debtors to use what is essentially a creditor's protective tool – an involuntary petition – for the purpose of achieving what the debtor could not legitimately achieve on its own. The message it seems from *Kingston Square* is clear – there is no reason to labour over bankruptcy remote provisions in a SPV's bylaws because they are easily circumvented. All that is necessary for a SPV seeking to avoid the bankruptcy remote provisions is a supply of "friendly" creditors.

Thus, this indicates that a SPV is never bankruptcy proof and certainly its bankruptcy remoteness can be attacked by persons who are not potential threats to the SPV. The SPV although created to serve a purpose with limited operational parameters is nevertheless still a corporate entity liable under the provisions of bankruptcy law. Careful construction and operation of the SPV can deter, to some extent, any threats of bankruptcy posed by creditors and, as just discussed, debtors. One should, however, never be complacent in the belief that a SPV will survive all attacks of causing it into bankruptcy.

Solutions to this problem unfortunately only exist in loopholes of bankruptcy law and judicial thought. Since the corporate entity is widely used as a SPV rather than employing a trust for securitisation, bankruptcy remoteness will always need to be analysed and monitored throughout the life of the SPV. One solution the author suggests which can eliminate some uncertainty of bankruptcy remoteness is to have a SPV set up as a trust which owns the receivables but is controlled in part by a corporate entity. The corporate issues the securities while the trust owns and manages the receivables. (This solution may introduce the next generation of SPVs and forms part of the author's post-doctoral research.)

The second mechanism introduced to achieve bankruptcy remoteness for the SPV is creating an independent director to operate the SPV alongside its existing directors. The concept of having an independent director is one that originated in the US. Its aim is to reduce any risk of voluntary bankruptcy by stating in the documentation pertaining to the formation of the SPV that the concurring vote of the independent director is imperative in matters relating to selling or otherwise transferring the SPV's property or the voluntary placing of the SPV into bankruptcy or other insolvency proceedings (Ellis, 1999: 12-14).

The SPV's documents will require that a unanimous vote is required to place the SPV into voluntary bankruptcy. Thus, the presence of an independent director ensures that such unanimity is not achieved because the independent director is positioned to look after the interests of the investors and is under the obligation to vote against any voluntary petition for bankruptcy. Having such a director satisfies the credit rating agency too since it shows that investors would not be led into a loss making scenario – assets frozen and prioritised to satisfy creditors (Standard and Poor's, 1993i).

But how important is the presence of the independent director? Assume that the SPV is experiencing financial problems which can potentially affect investors. Now assume that the board agrees that voluntary bankruptcy is the only viable solution. The independent director is under an obligation to protect the investors and the SPV from voluntary bankruptcy. However, in the real world this poses a conflict of interest issue for the independent director – who does he protect – the investors or the shareholders? As a director of the SPV he owes fiduciary duties to the shareholders which need to be balanced with his obligation to protect investors against leading the SPV into voluntary bankruptcy. Thus, in reality he owes duties to both the shareholders and the investors.

The unwritten rules relating to the construction of the SPV state that the independent director is created solely for the protection of the investors. However, the written rules relating to such construction state that each director owes fiduciary duties to the company and its shareholders and must diligently act in the interests of the SPV. So which rules take priority?

A lawyer will say that the written rules will guide a court should a dispute arise. However, where does this leave investors who have relied on the unwritten rules to safe guard their investment? Further, how independent is the independent director if he needs to balance fiduciary duties with duties to the investor? It seems that bankruptcy remote provisions are ripe for judicial scrutiny which would certainly add clarity to the validity of such provisions. Moreover, it seems that such provisions can become the subject of litigation brought by SPV shareholders and investors. For example, the shareholders bring an action against the independent director for breach of fiduciary duty based on a refusal to sign a petition when it is in the best interest of the SPV. Or if a petition is filed by the board without the consent of the independent director can be challenged for lacking the director's consent.

The investors too can bring claims against the originator and the SPV's directors for failing to protect investors if such provisions fail to protect. Bankruptcy remote provisions do have the potential to be challenged in the courts – but to date there has been no direct case on the issue. In closing, though such provisions are drafted with the intention of protecting investors and gaining a better credit rating, it seems that in the real world this far from reality. In all cases such provisions will work but will work with the overhead threat that they can fail under certain the circumstances.

6. PERFECTION OF SECURITY INTEREST

Perfecting the security interest in the purchased receivables is an important undertaking as it secures the SPV's title against subsequent purchasers or encumbrances who may have purchased an interest in the same receivables. Although this would not ideally occur in practice, it is advisable that any assets transferred by the originator to the SPV are perfected as belonging solely to the SPV. Where the transfer has fallen short of a true sale then it is considered imperative that all security interests in the pool of receivables are perfected according to the law of the jurisdiction in which the SPV is incorporated and in which the receivables originated, if sold cross border. Even if the transfer is conducted according to the true sale criterion, perfection of security interests is still advisable since perfection does not guarantee priority over subsequent incumbrances which, of course, is decided by the priority rules. Legal opinions are, of course, needed when dealing with perfection issues. However, under English law charges by an English company are registerable even if created outside the UK and moreover, a charge on property in England by an overseas company is registerable under s.395 *Companies Act* 1985 regardless of whether the overseas company is not incorporated under the Act.

Section 396 *Companies Act* 1985 lists the categories of charge by a company which require registration. However, its relevance as far as a SPV is concern is that it only needs compliance if the pool of receivables contains charges over land, ships and aircrafts. Charges over book debts are governed by s.395 CA 1985. Section 396 (4) CA 1985 states that "charges" includes mortgages. Book debts, according to Professor Goode, are debts 'arising in the course of a trader's business… [and]…entered in a trader's [book]' (Goode, 2003). This wide definition encompasses all forms of revolving receivables, such as trade and auto receivables. Negotiable instruments are exempt from registration so their mere possession perfects the security interest. The exemption applies to bearer form securities so that the concept of negotiability is not interfered with. There have been asset-backed securities created by tying negotiable instruments with swaps to create a desired payment.

In the US, perfection rules are found in Article 9 of the *Uniform Commercial*

Code (UCC). In short, all interests in "chattel paper" and "instruments" (as defined by Art. 9) are registerable by either filing a UCC-1 financing statement against the debtor or taking possession of the "chattel paper". However, there seems to be some confusion with regards to mortgages. Section 9-104(j) excludes from Article 9 'the creation or transfer of an interest in or lien on real estate' implying that mortgages are not covered by the ambit of Article 9. Section 9-102(3) states, however, that Article 9 applies to obligation secured by transaction or interests outside the ambit of Article 9. The safest answer it seems is to perfect the mortgage interest according local real estate law regardless of the wording of Article 9.

7. ASSET BACKED SECURITIES IN THE UK

Since the birth of asset-backed securities (the product of securitisation) capital markets have seen and handled a range of imaginatively named securities that are generally classed as asset-backed securities, for example, CLEOS (Collaterised Lease Equipment Obligation), FRENDS (Floating Rate Enhanced Debt Securities), CARs (Certificate of Automobile Receivables), CARDs (Certificates of Amortising Revolving Debts). Asset-backed securities can be categorised, based on their payment mechanism, as either "pass-through" obligations or "pay-through" obligations.

"Pass-through" obligations are ideally issued if the payment pattern of the underlying pool of receivables corresponds with the payment pattern of the securities issued. Thus, scheduled principal and interest payments from the receivables are passed through to the investors who have purchased an undivided fractional share of the receivable pool. Because the issuer under this payment pattern acts merely as an *interface* allowing received payments to be formally passed through it and on to the investors, the issuer does not need to be formed as a business entity with the capacity to trade. In the US, the issuer, in this situation, is formed as a grantor trust, which acquires a non-taxable status, thus under US Dept. of Treasury Regulation s. 301.7701-4, the trust must not conduct itself as a business for profit, must not have the capacity to reinvest receivables or alter the terms of any investment, and finally must issue a single class of securities. In the UK, the issuer is formed as a non-trading trust, which is exempt from the imposition of taxation.

However, where the payment pattern of the receivables is unpredictable then issuing pass-through securities would not be ideal since investors will have been promised a fixed sum each month and failure to deliver will trigger a default. With this type of payment pattern the securities would need to be "pay-through", in that the investors are paid interest payments initially with the principal being paid over the last quarter of the securities' life or in a lump sum on the last day of the securities' life – in practice, this is called a bullet payment. The issuer, in this situation, will need the capacity to reinvest receivables and undertake the maintenance of (perhaps) a multiple class of securities. Under the restrictive regulations pertaining to non-trading or grantor trusts these activities are not possible since a breach of the regulations converts the non-trading or grantor status to a trading or an owner trust, respectively. Thus, the objective to secure and maintain tax-exempt status will have been lost.

The law and regulatory procedure which permits a securities' offering will be dictated by the jurisdiction in which the SPV intends to offer securities. In the UK, the *Financial Services and Markets Act* 2000 and the *FSA Listing Rules* prepared thereunder collectively govern the offering of asset backed securities both through a public and private issue. Asset backed securities are issued either as commercial paper or as bonds with a specified maturity date. Commercial paper is a short term security which matures within 365 days of its issue. It is typically issued where the underlying pool of receivables has a life of 365 days or structured so that it lives for 365 days and any residual amount is sold back to the originator. In contrast, bonds are issued with a life ranging between 2 to 25 years depending on the life of the underlying pool of receivables.

The securities' offering is undertaken by the SPV with the assistance of an investment banker. The investment banker acts as an intermediary for legal and practical purposes. From a legal standpoint, the FMSA only permits certain persons to undertake investment activities – s.21 provides,

> (1) A person ("A") must not, in the course of business, communicate an invitation or inducement to engage in investment activity.
>
> (2) But subsection (1) does not apply if - (a) A is an authorised person;

In the UK, the banker will make an application to the "competent authority" – FSA – to have securities issued to the public or privately. The application includes details of the issuer, its financial position given by the accountant and brief details about the bond issue. This application is either approved or rejected. Typically, it is rejected if the included information lacks detail or is confusing. Once approved the issuer then compiles a prospectus – all new asset backed securities issued must be sold with a prospectus – ss. 85 and 86 *FSMA* 2000,

> s. 85(1) If listing rules made under section 84 require a prospectus to be published before particular new securities are admitted to the official list, it is unlawful for any of those securities to be offered to the public in the United Kingdom before the required prospectus is published.

The *FSA Listing Rules* further provide,

> s. 85(1) It is unlawful for transferable securities to which this subsection applies to be offered to the public in the United Kingdom unless an approved prospectus has been made available to the public before the offer is made.

If the SPV intends to offer asset backed securities to select group of investors then s.86 is triggered. This section deals with when an approved prospectus does not have been made available to the public before the securities issue – the section lists certain persons or circumstances. In essence, s.86 will apply when the SPV is offering asset backed securities by way of private placement to *qualified investors* who are recognised by the FSA as experienced and educated persons – in practice, dealers.

A prospectus is a very important document prepared by the SPV, with the assistance of the investment banker, when offering securities to the public. If the securities issue is by private placement then an *offering memorandum* is prepared and distributed to the investors. Both documents, although they differ aesthetically, are similar in nature. They are both designed to give an investor information (factual and opinions) about the SPV and its securities. The difference in their names is simply to help distinguish an offering to the public from one made by private placement. For ease, the word "prospectus" will be used to mean both a prospectus and an offering memorandum.

A prospectus will first contain a *summary* (s.87A(5) which in no more than 2,500 words 'briefly and in non-technical language, [conveys] the essential characteristics of, and risks associated with, the issuer' (s.87A(6). The summary must also contain a warning that such summary must be read as an introduction and any investment decision should be based on consideration of the prospectus as a whole. Article 10 the *Prospectus Directive Regulation* (No 2004/809/EC) sets out the minimum information which must be incorporated into a prospectus offering asset backed securities. Article 10 makes reference to Annex VII and Annex VIII of the PDR which actually lists the minimum information, as follows:

Annex VII:

1. PERSONS RESPONSIBLE

1.1 All persons responsible for the information given in the Registration Document and, as the case may be, for certain parts of it, with, in the latter case, an indication of such parts. In the case of natural persons including members of the issuer's administrative, management or supervisory bodies indicate the name and function of the person; in case of legal persons indicate the name and registered office.

1.2 A declaration by those responsible for the registration document that, having taken all reasonable care to ensure that such is the case, the information given in the registration document is, to the best of their knowledge, in accordance with the facts and does not omit anything likely to affect its import. As the case may be, declaration by those responsible for certain parts of the registration document that having taken all reasonable care to ensure that such is the case, the information contained in that part of the registration document for which they are responsible is, to the best of their knowledge, in accordance with the facts and contains no omission likely to affect its import.

2. STATUTORY AUDITORS

2.1 Names and addresses of the issuer's auditors for the period covered by the historical financial information (together with any membership of any relevant professional body).

3. RISK FACTORS

3.1 The document must prominently disclose risk factors in a section headed "Risk Factors" that are specific to the issuer and its industry.

4. INFORMATION ABOUT THE ISSUER:

4.1 A statement whether the issuer has been established as a special purpose vehicle or entity for the purpose of issuing asset backed securities;

4.2 The legal and commercial name of the issuer;

4.3 The place of registration of the issuer and its registration number;

4.4 The date of incorporation and the length of life of the issuer, except where indefinite; and

4.5 The domicile and legal form of the issuer, the legislation under which the issuer operates its country of incorporation and the address and telephone number of its registered office (or principal place of business if different from its registered office).

4.6 Description of the amount of the issuer's authorised and issued capital and the amount of any capital agreed to be issued, the number and classes of the securities of which it is composed.

5. BUSINESS OVERVIEW

5.1 A brief description of the issuer's principal activities.

5.2 A global overview of the parties to the securitisation program including information on the direct or indirect ownership or control between those parties.

6. ADMINISTRATIVE, MANAGEMENT AND SUPERVISORY BODIES

6.1 Names, business addresses and functions in the issuer of the following persons, and an indication of the principal activities performed by them outside the issuer where these are significant with respect to that issuer:

(a) members of the administrative, management or supervisory bodies; and

(b) partners with unlimited liability, in the case of a limited partnership with a share capital.

7. MAJOR SHAREHOLDERS

7.1 To the extent known to the issuer, state whether the issuer is directly or indirectly owned or controlled and by whom, and describe the nature of such control and describe the measures in place to ensure that such control is not abused.

8. FINANCIAL INFORMATION CONCERNING THE ISSUER'S ASSETS AND LIABILITIES, FINANCIAL POSITION, AND PROFITS AND LOSSES

8.1 Where, since the date of incorporation or establishment, an issuer has not commenced operations and no financial statements have been made up as at the date of the registration document, a statement to that effect shall be provided in the registration document.

8.2 Historical Financial Information

…

The most recent year's historical financial information must be presented and prepared in a form consistent with that which will be adopted in the issuer's next annual published financial statements having regard to accounting standards and policies and legislation applicable to such annual financial statements … If the audited financial information is prepared according to national accounting standards, the financial information required under this heading must include at least the following:

(a) the balance sheet;

(b) the income statement; and

(c) the accounting policies and explanatory notes.

The historical annual financial information must be independently audited or reported on as to whether or not, for the purposes of the registration document, it gives a true and fair view, in accordance with auditing standards applicable in a Member State or an equivalent standard.

…

8.3 Legal and arbitration proceedings

Information on any governmental, legal or arbitration proceedings (including any such proceedings which are pending or threatened of which the company is aware), during a period covering at least the previous 12 months, which may have, or have had in the recent past, significant effects on the issuer and/or group's financial position or profitability, or provide an appropriate negative statement.

8.4 Material adverse change in the issuer's financial position

Where an issuer has prepared financial statements, include a statement that there has been no material adverse change in the financial position or prospects of the issuer since the date of its last published audited financial statements. Where a material adverse change has occurred, this must be disclosed in the registration document.

9. THIRD PARTY INFORMATION AND STATEMENT BY EXPERTS AND DECLARATIONS OF ANY INTEREST

9.1 Where a statement or report attributed to a person as an expert is included in the Registration Document, provide such person's name, business address, qualifications and material interest if any in the issuer. If the report has been produced at the issuer's request a statement to that effect that such statement or report is included, in the form and context in which it is included, with the consent of that person who has authorised the contents of that part of the Registration Document.

9.2 Where information has been sourced from a third party, provide a confirmation that this information has been accurately reproduced and that as far as the issuer is aware and is able to ascertain from information published by that third party, no facts have been omitted which would render the reproduced information inaccurate or misleading. In addition, the issuer shall identify the source(s) of the information.

10. DOCUMENTS ON DISPLAY

10.1 A statement that for the life of the registration document the following documents (or copies thereof), where applicable, may be inspected:

(a) the memorandum and articles of association of the issuer;

(b) all reports, letters, and other documents, historical financial information, valuations and statements prepared by any expert at the issuer's request any part of which is included or referred to in the registration document; and

(c) the historical financial information of the issuer or, in the case of a group, the historical financial information of the issuer and its subsidiary undertakings for each of the two financial years preceding the publication of the registration document.

An indication of where the documents on display may be inspected, by physical or electronic means.

Annex VIII:

1 THE SECURITIES

1.1 The minimum denomination of an issue.

1.2 Where information is disclosed about an undertaking/obligor which is not involved in the issue, provide a confirmation that the information relating to the undertaking/obligor has been accurately reproduced from information published by the undertaking/obligor. So far as the issuer is aware and is able to ascertain from information published by the undertaking/obligor no facts have been omitted which would render the reproduced information misleading. In addition, identify the source(s) of information in the Securities Note that has been reproduced from information published by an undertaking/obligor.

2 THE UNDERLYING ASSETS

2.1 Confirmation that the securitised assets backing the issue have characteristics that demonstrate capacity to produce funds to service any payments due and payable on the securities.

2.2 In respect of a pool of discrete assets backing the issue:

2.2.1 the legal jurisdiction by which the pool of assets is governed

2.2.2 (a) In the case of a small number of easily identifiable obligors, a general description of each obligor.

(b) In all other cases, a description of: the general characteristics of the obligors; and the economic environment, as well as global statistical data referred to the securitised assets,

2.2.3 the legal nature of the assets;

2.2.4 the expiry or maturity date(s) of the assets;

2.2.5 the amount of the assets;

2.2.6 loan to value ratio or level of collateralisation;

2.2.7 the method of origination or creation of the assets, and for loans and credit agreements, the principal lending criteria and an indication of any loans which do not meet these criteria and any rights or obligations to make further advances;

2.2.8 an indication of significant representations and collaterals given to the issuer relating to the assets;

2.2.9 any rights to substitute the assets and a description of the manner in which and the type of assets which may be so substituted; if there is any capacity to substitute assets with a different class or quality of assets a statement to that effect together with a description of the impact of such substitution; and

2.2.10 a description of any relevant insurance policies relating to the assets. Any concentration with one insurer must be disclosed if it is material to the transaction.

2.2.11 Where the assets comprise obligations of 5 or fewer obligors which are legal persons or where an obligor accounts for 20% or more of the assets, or where an obligor accounts for a material portion of the assets, so far as the issuer is aware and/or is able to ascertain from information published by the obligor(s) indicate either of the following:

(a) information relating to each obligor as if it were an issuer drafting a Registration Document for debt and derivative securities with an individual denomination of at least EUR 50 000; and

(b) if an obligor or guarantor has securities already admitted to trading on a regulated or equivalent market or the obligations are guaranteed by an entity admitted to trading on a regulated or equivalent market, the name, address, country of incorporation, nature of business and name of the market in which its securities are admitted.

2.2.12 If a relationship exists that is material to the issue, between the issuer, guarantor and obligor, details of the principal terms of that relationship.

2.2.13 Where the assets comprise obligations that are not traded on a regulated or equivalent market, a description of the principal terms and conditions of the obligations.

2.2.14 Where the assets comprise equity securities that are admitted to trading on a regulated or equivalent market indicate the following:

(a) a description of the securities;

(b) a description of the market on which they are traded including its date of establishment, how price information is published, an indication of daily trading volumes, information as to the standing of the market in the country and the name of the market's regulatory authority; and

(c) the frequency with which prices of the relevant securities, are published.

2.2.15 Where more than ten (10) per cent of the assets comprise equity securities that are not traded on a regulated or equivalent market, a description of those equity securities and equivalent information to that contained in the schedule for share Registration Document in respect of each issuer of those securities.

2.2.16 Where a material portion of the assets are secured on or backed by real property, a valuation report relating to the property setting out both the valuation of the property and cash flow/income streams. Compliance with this disclosure is not required if the issue is of securities backed by mortgage loans with property as security, where there has been no revaluation of the properties for the purpose of the issue, and it is clearly stated that the valuations quoted are as at the date of the original initial mortgage loan origination.

2.3 In respect of an actively managed pool of assets backing the issue:

2.3.1 equivalent information to that contained in items 2.1 and 2.2 to allow an assessment of the type, quality, sufficiency and liquidity of the asset types in the portfolio which will secure the issue; and

2.3.2 the parameters within which investments can be made, the name and description of the entity responsible for such management including a description of that entity's expertise and experience, a summary of the provisions relating to the termination of the appointment of such entity and the appointment of an alternative management entity, and a description of that entity's relationship with any other parties to the issue.

2. 4 Where an issuer proposes to issue further securities backed by the same assets, a prominent statement to that effect and unless those further securities are fungible with or are subordinated to those classes of existing debt, a description of how the holders of that class will be informed.

3 STRUCTURE AND CASH FLOW

3.1 Description of the structure of the transaction, including, if necessary, a structure diagram.

3.2 Description of the entities participating in the issue and description of the functions to be performed by them.

3.3 Description of the method and date of the sale, transfer, novation or assignment of the assets or of any rights and/or obligations in the assets to the issuer or, where applicable, the manner and time period in which the proceeds from the issue will be fully invested by the issuer.

3.4 An explanation of the flow of funds including:

3.4.1 how the cash flow from the assets will meet the issuer's obligations to holders of the securities, including, if necessary, a financial service table and a description of the assumptions used in developing the table;

3.4.2 information on any credit enhancements, an indication of where material potential liquidity shortfalls may occur and the availability of any liquidity supports and indication of provisions designed to cover interest/principal shortfall risks;

3.4.3 without prejudice to item 3.4.2, details of any subordinated debt finance;

3.4.4 an indication of any investment parameters for the investment of temporary liquidity surpluses and description of the parties responsible for such investment;

3.4.5 how payments are collected in respect of the assets;

3.4.6 the order of priority of payments made by the issuer to the holders of the class of securities in question;

3.4.7 details of any other arrangements upon which payments of interest and principal to investors are dependent;

3.5 the name, address and significant business activities of the originators of the securitised assets;

3.6 where the return on, and/or repayment of the security is linked to the performance or credit of other assets which are not assets of the issuer, items 2.2 and 2.3 are necessary;

3.7 the name, address and significant business activities of the administrator, calculation agent or equivalent, together with a summary of the administrator's/calculation agents responsibilities, their relationship with the originator or the creator of the assets and a summary of the provisions relating to the termination of the appointment of the administrator/calculation agent and the appointment of an alternative administrator/calculation agent; and

3.8 the names and addresses and brief description of:

(a) any swap counterparties and any providers of other material forms of credit/liquidity enhancement;

(b) the banks with which the main accounts relating to the transaction are held.

4. POST ISSUANCE REPORTING

4.1 Indication in the prospectus whether or not it intends to provide post-issuance transaction information regarding securities to be admitted to trading and the performance of the underlying collateral. Where the issuer has indicated that it intends to report such information, specify in the prospectus what information will be reported, where such information can be obtained, and the frequency with which such information will be reported.

The FMSA makes it clear that its underlying policy is based, in part, on investor protection, meaning, that one of the aims of the FMSA is protect investor confidence in the financial markets. This protection has be translated into the FMSA by having certain provisions which (i) make it an offence to attack investor confidence by providing insufficient and/or misleading information in a prospectus, and (ii) levying financial penalties on those who contravene the provisions of the FMSA. Each person contributing to the prospectus is responsible for their respective contribution, thus, each party is potentially exposed to some liability if their contribution is inaccurate or misleading in any way. Accordingly, the investment banker can be punished under s.206 FMSA for contravening the FMSA in its capacity as an authorised person; and the issuer and third parties who have contributed to the prospectus can be punished under ss. 90 and 91 FMSA. The FMSA also has in place additional remedies such allowing the FSA to seek an injunction or restitution order against those who potentially can contravene the FMSA, or who have benefited financially by a contravention.

The SPV must ensure that it complies with the provision of the FMSA (and the FSA Listing Rules drafted thereunder) if it intends to issue asset backed securities in the UK. Failure to do so is not only an offence and financially detrimental, but also professionally embarrassing.

CHAPTER 6 SECURITISATION FACILITATES MONEY LAUNDERING?

1. INTRODUCTION

This chapter seeks to discuss the essence and purpose of the thesis – *is it possible for securitisation to be used and abused so as to facilitate money laundering*? In previous chapters the author examined what securitisation is, and how it works from both a legal and practical perspective; knowledge which is essential and a good foundation in order to answer the above question. As stated earlier, the inspiration behind this research was sparked by the fraudulent activities committed by certain executives at the energy giant that once existed as Enron. The Enron scandal as it unfolded and was reported, uncovered what is now a known fact, that securitisation can be used and abused to commit fraud, a fraud which will be discussed later in this chapter. Although the wrongful activities behind the Enron scandal only demonstrate that securitisation can be used and abused to raise funds in a fraudulent manner, such disclosure inspires one to think whether securitisation can be used and abused to commit other forms of financial crime.

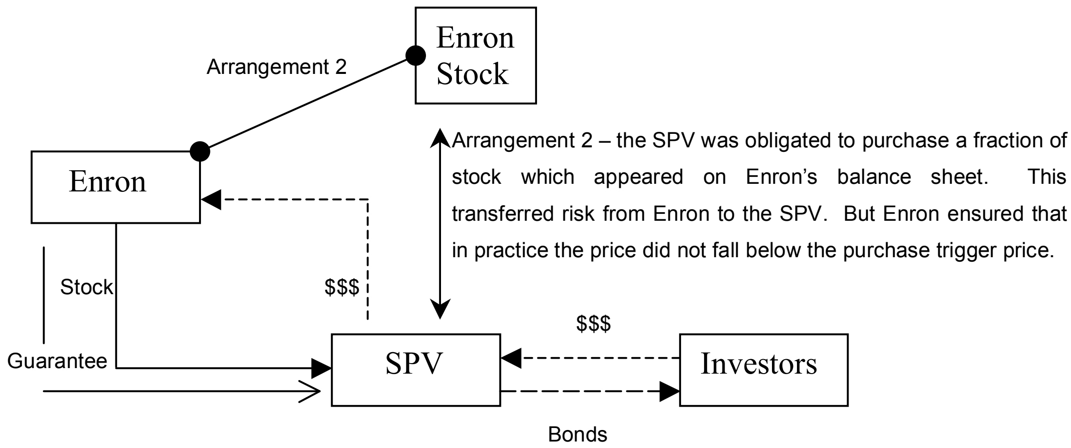
To narrow the inquiry to the extent that it can be practically tested, one needs to formalise a workable hypothesis that connects the activities behind the Enron scandal, securitisation, and money laundering. Thus, the question, *is it possible for securitisation to be used and abused so as to facilitate money laundering*, then becomes, as a working hypothesis: *if the activities behind the Enron scandal are related to the vulnerabilities of a securitisation transaction, then such vulnerabilities may be exploited to the extent that a securitisation transaction may facilitate money laundering.*

2. THE ENRON SCANDAL: WHAT CAUSED IT?

An example of how securitisation can be abused to facilitate financial crime was exposed by the Enron scandal. The Enron scandal perpetrated by certain executives at the Houston-based energy giant and its auditors succeeded, in part, because of the active part played by several prominent bankers – J P Morgan Chase, Citigroup, Merrill Lynch, Credit Suisse First Boston, Canadian Imperial Bank of Commerce (CIBC), Bank of America, Barclays Bank, Deutsche Bank and Lehman Brothers. These key players, in a series of fraudulent transactions, ultimately cost shareholders more than $25 billion. It was uncovered that almost $1.2 billion was earned through insider trading by 28 Enron directors and officers (Senate Committee, 2002: 3).

The methodology was as follows (Schwarcz, 2002). Enron was a corporate giant which presented falsified information to the world with regards to its business operations and prosperity. Enron set up a SPV to which it transferred its own stock The SPV purchased this stock by issuing bonds to investors supported by the cashflow and creditworthiness of the Enron stock. Because Enron was purportedly successful the stock and additional guarantees given by Enron secured a successful bonds issue. The bond proceeds were passed back to Enron and invested in Enron's other business ventures without appearing on Enron's financial statements.

Enron also created an arrangement whereby the SPV would be obliged to purchase other stock which Enron owned if the price of that stock fell to a pre-arranged price. This was a separate contract – Enron sold a call option (rights to purchase stock at a fixed pre-arranged price or at a specified time). The SPV would purchase this stock using the cashflow from the Enron stock less any interest payments to the investors.



(Source: Schwarcz, 2002)

The structure was carefully put together so that the SPV would not face any financial difficulty – Enron ensured that its stock price would not fall so that its guarantee to the SPV would not materialise. It did this by continuing to give a conceited view of its trading and success which consequently kept its stock price at a safe level. It also ensured that the second arrangement it had with the SPV would not cause unforeseeable loss to the SPV. Again, its conceited operations kept this second stock price at a safe level so that the SPV was not obliged to purchase this stock.

This was the structure of Enron's dealings – multiplied by more than 3000 times – Enron had over 3000 SPVs which formed a huge operation of more than 3000 securitisation transactions. This added the complexity to Enron's structure. Enron's trading was, in part, nothing more than bank borrowings which, with the aid of balance sheet manipulation, appeared as income. This income gave the impression that Enron was a successful energy giant. Thus, Enron's stock was falsely inflated which Enron used in the transfer to the SPVs for the bond issues. Further, the bankers facilitated the bond issues supported by the sale of the overvalued Enron stock. For example, as underwriters, J P Morgan Chase helped Enron raise $2 billion in publicly traded securities that were later almost worthless (Powers, 2002: 14-17).

The bankers, further, played a dual role in the elaborate scheme – helping conceal the true state of Enron's precarious financial condition while securities' analysts at the same banks were making false and inflated assessments of Enron to entice investors. As a result, Enron executives were able to deceive investors by moving billions of dollars of debt off its balance sheet and artificially inflating the value of Enron stock.

Enron's financial manipulations finally became public and consequently the stock collapsed in November 2001 triggering the guarantees it owed to the 3000 and more SPVs. The SPVs could not repay the bondholders because Enron's stock (the receivables supporting the bonds) were dropping in value. Moody's, the credit rating agency, was asked by the bankers to keep Enron's credit rating unchanged until the bankers could arrange a solution to avoid insolvency. However, the combined effect of the falling stock, the publicity and the potential legal proceedings forced Enron to file for bankruptcy on December 2, 2001 with losses estimated at more than $25 billion (Powers, 2002: 36; Senate Committee, 2002: 105-106). The Enron scam shows some significant points – stock can be used as receivables; accounting rules can be manipulated; the more SPVs in a structure the more complicated it appears; disclosure can be limited to what an average investor can understand; and professionals can be utilised to facilitate fraud.

From a theoretical perspective, the activities behind the Enron scandal fit within what is described as *financial crime*. In simple terms financial crime is any non-violent crime resulting in a financial loss. An elaborate definition incorporates an array of dishonest financial activities which cause loss, for example, 'the concept of financial abuse [includes] illegal financial activities, many of which have the potential to harm financial systems, and legal activities that exploit undesirable features of tax and regulatory systems' (IMF, 2001: 5). This definition, just one of many which, reflects with some accuracy the activities exposed in the Enron scandal. An analysis of the Enron scandal exposes certain vulnerabilities of a securitisation transaction such that there is little, if any, detection by the authorities of what goes on *behind the scenes* in a securitisation transaction; there is virtually no method for participants to detect wrongdoing in a securitisation transaction; the credit rating agencies who analyse receivables have no ability to detect any wrongdoing underlying the receivables; and the time within which a transaction closes is insufficient to allow a thorough verification of its key components by those parties involved.

3. WHAT IS MONEY LAUNDERING?

Money laundering is a financial crime, defined by many academics, all of whom follow the same underlying definition, that it is a process of converting money or money equivalent which derives from criminal activity into money or its equivalent which then appears to be legally generated. Lyman offers a useful definition, 'the term 'money laundering' refers to the transformation of illegally obtained currency to that which appears legitimate. In addition, it is the concealment of the illegal source of the income or its applications' (1989: 7-8). A more comprehensive definition is 'the process whereby proceeds, reasonably believed to have been derived from criminal activity, are transported, transferred, transformed, converted, or intermingled with legitimate funds, for the purpose of concealing or disguising the true nature, source, disposition, movement or ownership of those proceeds. The goal of the money laundering process is to make funds derived from, or associated with illicit activity appear legitimate' (US Customs, 1990: 1149).

Levi's definition focuses upon Article 1 of the draft European Community Directive of March 1990, and defines money laundering as, 'the conversion or transfer of property, knowing that such property is derived from a serious crime, for the purpose of concealing or disguising the illicit origin of the property or of assisting any person who is involved in committing such an offence or offences to evade the legal consequences of his action, and the concealment or disguise of the true nature, source, location, disposition, movement, rights with respect to, or ownership of property, knowing that such property is derived from a serious crime' (1991: 109-125).

If correctly done it allows criminals to gain and maintain control over their proceeds and provide a legitimate cover for the source of the income. The process of laundering plays a crucial role in allowing the drug trafficker, the terrorist, the organised criminal gang, the insider trader, the tax evader, to name a few, to avoid suspicion that sudden wealth brings, if such wealth derives from criminal activity. So how is money laundered? The process itself occurs over three stages – *placement, layering* and *integration* (Ehrenfeld, 1992: 34-41).

Placement is the first stage where the launderer will introduce the dirty money into the banking and financial system with the aim of "washing" it. Usually such money is placed under a disguise into the banking or financial system so as to reduce detection from the authorities, and any links with the launderer's criminal activities. The disguise usually takes the form of a legitimate business operation capable of generating either a stable or a fluctuating amount of income. The launderer is careful not to arouse suspicion and embarks upon an elaborate cover up operation by creating invoices, receipts or any other documentary evidence which can substantiate the income and the business operation. The first stage of laundering is where the initial alarm bells are likely to ring since the launderer is introducing the proceeds into the banking and financial system against the response to laundering by the financial institutions through which such funds must pass.

Layering occurs once the proceeds have entered the financial system and start going through the cleaning process. Since the aim of laundering is to dissociate the proceeds from its criminal origin the proceeds are placed through a series of transactions which act as layers of cover so as to eliminate any audit trail. The financial system offers numerous opportunities which can be used to act as layers of cover. Typically, the proceeds are wired to offshore bank accounts and then split into several portions which are then used to purchase financial products like shares, bonds and other products where details of ownership can be disguised. Electronic money has introduced another opportunity where proceeds can be transferred with little ownership disclosure or complete anonymity (IMF, 2001: 7).

Integration is the final stage and the aim here is to introduce the proceeds back into the legitimate financial system and associate the proceeds with the launderer or its operations so to give the impression that such proceeds have been legitimately earned. At this stage any audit trail will have been broken and thus, making it difficult to distinguish legal and illegal wealth. The usual methods used for integration are the creation of anonymous companies in countries where the right to secrecy is guaranteed. The launderer is then able to grant itself loans out of the laundered money in the course of a future legal transaction. Furthermore, to increase its profits it will also claim tax relief on the loan repayments and charge itself interest on the loan. Alternatively, the launderer can send false export-import invoices – overvaluing goods – which allow the launderer to move money from one company and country to another with the invoices serving to verify the origin of the monies placed with financial institutions (Ehrenfeld, 1992: 43).

The ongoing battle against money laundering through laws and regulations is driven by a legislative policy with three aims: (i) asset detection/tracing; (ii) disruption; and (iii) asset seizure (Sergeant, 2003: 7). Asset tracing consists of following the trail of the proceeds from origin to the launderer's pocket. It is the trail that is created during the layering stage of money laundering. Governments have introduced laws and regulations which empower and assist law enforcement authorities to undertake asset tracing, for example, in the UK the *Proceeds of Crime Act* 2002 established the Assets Recovery Agency. Disruption means to disrupt the flow of money generated through illegitimate means. This is achieved to a varying degree by having in place laws and regulations which make it difficult for the launderer to move money around, for example, through a series of transactions (Lormel, 2005: 4). Asset seizure, in contrast, involves seizing the assets which are proven to be originated by the proceeds of crime. Asset seizure is triggered at the integration stage of the laundering operation – when the launderer retrieves the proceeds.

On an international scale the fight against money laundering is rooted in the *Forty Recommendations* of the Financial Action Task Force (FATF), an organisation set up by the Organisation for Economic Cooperation and Development (OECD) in 1989. Its purpose is to address the longstanding global problem of money laundering by issuing recommendations and directions to member and non-member nations, and periodically monitoring the problem and suggesting amendments accordingly.

The UK adopted and implemented some key suggestions by enacting the *Proceeds of Crime Act* 2002 which consolidates, updates and expands the money laundering offences in the *Criminal Justice Act* 1988, the *Drug Trafficking Act* 1994 and in the *Terrorism Act* 2000. Moreover, regulatory measures were introduced by the *Money Laundering Regulations* 1993 – superseded by the *Money Laundering Regulations* 2001, and again by the *Money Laundering Regulations* 2003. The salient points of the POCA are firstly, the creation of the Assets Recovery Agency which will investigate and commence both criminal and civil proceedings in order to trace and seize proceeds of crime. Secondly, allowing a court to assist in the seizure of assets through tougher confiscation orders. Thirdly, allowing the Assets Recovery Agency to pursue civil recovery of assets through the High Court. Fourthly, empowering certain authorities such as the police and Customs & Excise officers to seize large amounts of cash and finally, the introduction of tougher measures to assist in tracing assets and disrupting organised criminal enterprises on a domestic and international scale.

In the US the parallel legislation is the *Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act* 2001 (USA PATRIOT Act). One of the primary goals of the USA PATRIOT Act is to provide law enforcement authorities with enhanced investigative tools, new surveillance procedures, new immigration laws, and new and more rigorous anti-money laundering laws. In general, Title III of the USA PATRIOT Act amended two existing statutes – the *Money Laundering Control Act* 1986 which provided criminal laws designed to fight money laundering. The second statute was the *Bank Secrecy Act* 1970 which was a recordkeeping and reporting statute that applied to banking institutions generally. We shall see the effect of these rules when we examine whether securitisation facilitates money laundering.

4. CAN SECURITISATION FACILITATE MONEY LAUNDERING?

Now that a basis for the hypothesis has been established, the author will now turn to testing such hypothesis with the aid of empirical research, where necessary. Some of the empirical research carried out involved communications with individuals who agreed to participate on the condition that I maintain their anonymity given that their contribution may be considered to be of a frank and sensitive nature. Where this is applicable the author has omitted names.

To recap: *if the activities behind the Enron scandal are related to the vulnerabilities of a securitisation transaction, then such vulnerabilities may be exploited to the extent that a securitisation transaction may facilitate money laundering.*

The structure of securitisation is put together essentially by two main contracts – originator transferring receivables to the SPV, and the SPV issuing bonds to investors. The other contracts with third parties drive the structure so that it functions appropriately. Hypothetically, the originator will have a pool of receivables which is sold or pledged to the SPV. These receivables are rights to funds, which the originator has created through contracts with third parties. The receivables sold or pledged can be proceeds of crime – rights to payments created with third parties by contract to originate the proceeds or as part of the layering stage of laundering. Note that the receivables are intangible property since they have no physical existence other than being contractual rights forming part of the underlying contract with third parties and which are witnessed by paperwork. The receivables are placed into the financial system when they are transferred to the SPV – this assists the launderer by allowing the proceeds to achieve the layering stage. The launderer will exchange the dirty money for clean money when it receives the purchase price from the SPV – thus, achieving integration stage. Additionally, the launderer can raise funds in this way to further its criminal activities. Further, unless an entity directly declares criminal intentions or is subjected to criminal intelligence surveillance, there is very little prohibiting entities (including criminals or launderers) from securitising rights to payments – a possible affirmative conclusion of the hypothesis.

4.1 ORIGINATOR APPROACHES THE BANKER

The originator will approach a banker with the intention of raising finance either by removing receivables off its balance sheet or keeping the receivables and using them as security for finance. The banker usually requests audited accounts and an opinion from the originator's accountant which states the current financial position of the originator. This is used as a key tool to conceive a structure. The banker also requires information regarding the originator's business operations so a fuller picture can be achieved before calculating whether a securitisation would be appropriate (Schwarcz, 1993: 34-36).

The banker is known as the "producer" and "director" of the structure – it has the know-how and the contacts to make it materialise from paper to reality. The banker will compose the structure and instruct all the professionals involved. It is important to note that while the banker has good knowledge of securitisation it is not considered as an expert in every aspect of the structure. It has a general overview of all the aspects but relies heavily on the opinions of other professionals like lawyers, accountants and the credit rating agency. In the absence of any fallout, the banker usually has close ties with a law firm, an accountancy firm, placement agents, underwriters and a credit rating agency which have been created through a history of dealings. Thus, the investment banker is the biggest and most valuable client any lawyer or accountant will have.

Since the banker can produce and direct a structure, this position makes it possible for it to manipulate the structure or be abused. In other words, the banker is a key person who can facilitate a financial crime or be used to facilitate a financial crime. The originator will present itself as a prosperous business with a balance sheet of receivables. The receivables will appear as figures in the balance sheet – though supplementary information with the balance sheet will state the nature of the assets and explain the figures. Aside from this the balance sheet will not detail the receivables (PriceWaterhouseCoopers, London, interview: 14th May, 2003).

The next step in the process is isolating the receivables into a pool so that the banker can calculate how to structure the securitisation. The important point is that receivables are rights to payments which exist only by the contract that generated them. For example, a pool of mortgages is evidenced only by the mortgage contracts between the originator and the obligors and copies of property deeds held as security (Standard and Poor's, 1993a: 3). Alternatively, a pool of credit card receivables are evidenced only by computer generated printouts of account numbers and outstanding amounts (Standard and Poor's, 1997: 15). The originator will have in mind the amount of finance it wishes to raise and the amount of receivables it wishes to remove. These amounts are calculated with the aid of the originator's accountant. The isolation is discussed with the banker who will want to ensure that it is satisfied that firstly, the receivables exist, secondly, the originator is the legal and beneficial owner, thirdly, the originator is not breaching any prohibition clauses in other agreements by disposing the receivables, fourthly, the originator can transfer the receivables without causing loss to its operations, and finally, that the receivables have legitimate source (Standard and Poor's, London, interview: 23rd May, 2003).

Whether the receivables exist will depend on furnishing sufficient evidence as to their existence. Providing mortgage contracts and the property deeds would not be appropriate since they are confidential documents and moreover, it would be impractical to produce documentation evidencing every receivable in the pool. Thus, in practice, the originator makes representations that the receivables exist – this also satisfies that the originator is the owner, since if they exist on its financial statements the originator must be the owner. These representations also include a statement that removal of the receivables do not breach any prohibitions or do not significantly impact on the originator's business. The representations also include a statement that upon transfer of the receivables the SPV will acquire a first priority security interest in the receivables.

The receivables are presented as computer printouts which list the account numbers representing the underlying contracts together with outstanding amounts owed by the obligors. It is the outstanding amount that is transferred to the SPV. Each outstanding amount is identified by the account number which the obligor holds (Standard and Poor's, London). A typical pool can be evidenced by millions of accounts which combine to make the collateral and financial support for a multi-million bond issue. The originator transfers the accounts with a priority security interest to the SPV.

The banker relies very much on the representations given by the originator and the supporting documents presented. The banker warns that should the receivables not exist or they are removed in breach of any restrictions or such removal would economically damage the originator, then this would amount to fraud. Where the receivables do not exist then the originator is, in effect, raising finance without any collateral or honest representations. Where the originator transfers the receivables in breach of restrictions then this would place the SPV in a precarious position since firstly, the originator is in breach of contract with a third party and secondly, the receivables may need to be returned back to the originator if their removal economically damages the originator.

How much can the banker verify? Firstly, it is impractical to verify each receivable in a pool – for this reason the originator makes representations. The rating agency is the only professional which closely analyses the pool. However, a rating agency does not have the ability to check every receivable in a pool (Weiss Ratings). Secondly, the legal title can be verified by assumptions – if the receivables exist on the balance sheet then look to who is the owner of the balance sheet. Further, professionals such as the accountant and the originator's banker can confirm business operations. The computer printouts identify the receivables. Thus, the accumulative effect is a strong assumption, in the absence of evidence to the contrary, that the originator is the owner of the receivables.

Can the banker verify the source? Identifying the source is crucial in order to determine whether the receivables have a clean origin. The banker will examine the originator's business operations to ascertain its productivity, prosperity, and legitimacy based on the financial statements (including tax filings) and general knowledge within the originator's industry. However, it is possible for the originator to have business operations which do not appear in its financial statements. The use of special purpose vehicles is a popular method of taking assets and operations off financial statements – for example, Enron's growth is attributed to the existence of more than 3000 special purpose vehicles which did not appear in its financial statements.

For example, assume ABC Plc is a large producer and wholesaler of coffee. Now assume it isolates its wholesale operations and transfers them to a SPV in exchange for funds. ABC Plc then enters into a rolling contract whereby it sells its coffee to the SPV which then sells it on to retailers. The accounting consolidation rules, FRS 2, state that as long as ABC Plc does not own a majority of the voting rights in the SPV; has the right to strongly direct board meetings and/or decisions; has the right to exercise dominant influence over the SPV (para. 4 of Sch. 9 to the *Companies Act* 1989 provides that dominant influence occurs when the originator has a 'right to give directions with respect to the operating and financial policies of the [SPV] which its directors are obliged to comply with whether or not they are for the benefit of the [SPV])'; is a party to a control agreement involving the SPV; owns a participating interest in the SPV – the SPV will not appear in ABC Plc's financial statements. Now, if ABC Plc decides to become a party to a securitisation, its financial statements will not show the SPV as its subsidiary even if ABC Plc is indirectly controlling it and used it solely to raise off balance sheet finance. ABC Plc can appoint its directors as directors of the SPV as long as the majority of ABC's board is not connected with the SPV's board. Of course, conflict of interest issues will surface – but if ABC intends on hiding the SPV "subsidiary" it can turn a blind eye to any conflict of interest issues. This is what happened in the Enron affair (Powers, 2002: 64-66) – which although is governed by different legal and accounting rules, nevertheless shows that conflict of interest issues can be ignored if the party wishes to, and that no monitoring system is in place which can sound alarm bells in the event of such breach.

The banker will examine the originator's financial statements and any other documents given by its accountant and banker in order to work out the extent of the originator's business operations. The financial system relies very much on trust and integrity of the parties who utilise it (Fisse, 1992: 46-48). Each participant relies on the trust and integrity of each party it engages into business with and the banker is no exception to this. Thus, it will rely on what it is informed by the originator and other professionals who give their view as to the business operations of the originator – in addition to inspecting the documentation presented by the originator and any other findings which result from exercising due diligence. As long as it exercises due diligence and inquires reasonably, it has undertaken the level of investigation required by the unwritten rules of the financial community.

The receivables are intangible property which only exist as computer printouts and thus, can be falsely manufactured. So is it difficult for the banker to recognise proceeds of crime mingled with legitimate earnings? The answer is that it can be difficult given that the pool is composed of intangible assets which are evidenced merely by paperwork. The banker can only exercise due diligence and investigation to a certain extent before the investigation becomes impractical. One leading banker responded, 'it's a tough position to be in, particularly when dealing with a less known originator, but given the pressures we are under we have to go with what the originator will tell us' (Goldman Sachs, New York). When asked whether their press office shared this view the source declined to answer.

The press office of each organisation is in place to give information to the inquiring public. However, the press office will always lean towards giving answers or expressing views which do not undermine the organisation or the industry. It seems that the press office in this incident may not have given the same answer as the source. Another leading investment bank, JP Morgan, London, also expressed a similar view to Goldman Sachs but did not want their view expressed in writing.

Add to this the fact that every bond issue is structured according to a deadline which is often dictated by the capital markets – the banker will want to launch the bonds in a period of active favourable trading so that the bonds will be underwritten and sold. In practice, the period of active favourable trading is a short window of time, anything from a few hours to a few days, which has been picked out using reliable economic indicators and predictions (Bloomberg, 1997: 15-16). Thus, in most cases the banker may be working against the clock while ensuring that reasonable and practical investigations are undertaken.

Add to this the fact that the contents of the pool are under constant change – the receivables are exposed to prepayment and default risk which can be controlled by allocating reserves but nevertheless motivates the banker to act speedily (Standard and Poor's, 1993r: 27-28). Aside from investigating the originator, the banker is also responsible for instructing the other participants – credit rating agency, lawyers, management company, insurance companies and credit support providers.

Returning back to the question - is it difficult for the banker to recognise proceeds of crime mingled with legitimate earnings? – The answer it seems derives from whether it is reasonably possible and practical to recognise proceeds of crime during the period of time between receiving instructions from the originator to the time when the bonds are issued. In the author's view the pressures of the banker's duties makes it difficult for the banker to do anything more than what it already does. It is forced to accept the opinions of others (including the originator's) because of the pressures, and also not to unnecessarily question the integrity of the originator and others – this can be damaging for professional and business purposes. And moreover, how does one define reasonable due diligence?

A two-edged factor which warrants an isolated discussion is the underwriting duties of the banker. On the one hand, the banker needs to ensure that the bonds are issued according to the predicted active favourable trading period so that it is not left holding too much of the risks associated with the bonds. It works hard to ensure that the bonds are made attractive so that its dealers can sell them successfully during the selling period. One the other hand, it also needs to ensure that it has practically done what a reasonable banker could, would, and should do when composing the structure and investigating the originator and the pool. It will work hard to ensure that satisfactory investigations have been undertaken so that the bonds will sell while bearing in mind that it is holding the risk that should the bond issue fail due to lack of investigation or the pool fails, it will be left holding the underwriting risk. Thus, it seems that the banker has a financial interest which it needs to protect alongside a professional interest to ensure that it undertakes a reasonably possible and practical investigation of the originator and the pool. And this is driven by the window of time within which it must prepare the securitisation and launch the bonds. In other words, during the window of time it needs to investigate the originator while bearing in mind that it needs to ensure that the bonds are a success – it must not waste time on the investigations but focus on the launch of the bonds.

In conclusion, given the intangible nature of the receivables which can only be evidenced by paperwork prepared and controlled by the originator, and the tasks and multiple responsibilities of the banker, and the time frame within which the structure is composed and made effective, it seems that there is little which can detect and recognise a pool containing proceeds of crime. This affirmative answer can be further justified and strengthened by the conclusion (mentioned further in this chapter) that even the credit rating agency cannot recognise proceeds of crime who, in fact, closely analyse the pool.

4.2 WHAT DOES THE LAW EXPECT OF THE BANKER?

In the UK, the *Proceeds of Crime Act* 2002 (POCA), Money Laundering Regulations 2003, and the numerous press releases and advisory notes published by the Bank of England and more recently the Financial Services Authority are all based upon the requirement that a banker should know its customer. Further, that any suspicious transaction that indicates money laundering should be reported. Thus, the lawmaker has placed the onus of tackling money laundering firmly on the banker. The penalties for non compliance can be heavy – both criminal and financial sanctions can be placed on the banker for non compliance. For example, on 17th December 2002 the Financial Services Authority fined the Royal Bank of Scotland £750 000 for breaching the Money Laundering rules. An investigation showed that RBS failed ‘either to obtain sufficient 'know your customer' documentation adequately to establish customer identity or to retain such documentation, in an unacceptable number of new accounts opened across its retail network in early 2002’ (FSA/PN/123/2002).

Section 327 POCA 2002 provides,

(1) A person commits an offence if he -

(a) conceals criminal property;

(b) disguises criminal property;

(c) converts criminal property;

(d) transfers criminal property;

(e) removes criminal property from England and Wales or from Scotland or from Northern Ireland.

…

(3) Concealing or disguising criminal property includes concealing or disguising its nature, source, location, disposition, movement or ownership or any rights with respect to it.

Is the banker capable of committing all of the offences mentioned within this section? Since it is both the producer and director it can facilitate the concealing, disguising, transferring and removing from the jurisdiction proceeds of crime which have been mingled with legitimate earnings. But the important point to note is that the offences are only committed if it knows or should have known that the pool contains proceeds of crime. “Criminal property” is defined by s.340(3) as ‘property which the alleged offender knows or suspects constitutes or represents benefit from any criminal conduct’. Thus, the *mens rea* is in fact embedded in the definition of the “criminal property”. Consequently, if the banker does not suspect that the pool contains proceeds of crime, the pool is not “criminal property”. Conversely, where the banker has agreed with the originator to transfer proceeds of crime into the pool then obviously the offences have been committed.

However, where it has no knowledge of the pool’s true contents then it can escape liability by showing that the paperwork shown by the originator was proper and gave no cause for suspicion. Section 330(2)(b) introduces an 'objective' test which means that failure to disclose information about money laundering will amount to the commission of an offence where a person has 'reasonable grounds' for knowing or suspecting that another person is engaged in money laundering, even if they did not actually know or suspect that money laundering was taking place. The banker is only expected to exercise common sense of an experienced and skilled person – in other words, what would a reasonable banker have done in the circumstances? Earlier it was shown how receivables can be falsely manufactured thus, provided that nothing else in the surrounding circumstances causes suspicion, a reasonable banker would be expected to analyse the paperwork and rule that, based upon the paperwork, the receivables appear proper and legitimate – in other words, in the paperwork the proceeds are not highlighted in bold to attract attention.

The banker can convert the proceeds of crime when the receivables are transferred to the SPV and get converted from proceeds of crime to clean legitimate earnings. This is called layering. Section 328 provides,

> (1) A person commits an offence if he enters into or becomes concerned in an arrangement which he knows or suspects facilitates (by whatever means) the acquisition, retention, use or control of criminal property by or on behalf of another person.

Here the word 'arrangement' is interpreted to include a securitisation structure. The banker is capable of committing this offence since it will conceive the structure which will aid the 'acquisition, retention, use [and] control' of proceeds of crime (disguised as receivables) when the pool of receivables is created and ready to be assigned to the SPV. The banker is required by the provisions of POCA to report any knowledge or suspicion to an appointed Money Laundering Officer within the banker's organisation or to the police. The provision expects the report to be made within a reasonable period of time.

A critical examination of the policy behind POCA exposes two points, firstly, the onus is on the banker to investigate and report any suspicion or knowledge – the policy provides this without fully considering the abilities of the banker. Money laundering and financial crime is hidden behind a complicated fog of transactions and ingenuity which the banker may not recognise, let alone become suspicious of. Moreover, financial information reflecting intangible property can be falsified and manipulated to read whatever its author intends. Thus, the originator can create a pool of whatever it intends – or the banker can assist and create a pool of whatever they intend – the paperwork can be falsified and manipulated.

The second point exposed is that the policy seems to provide an incentive to investigate and report suspicion and knowledge by imposing criminal sanctions for non-reporting – s.334 POCA 2002 provides, 'a person guilty of an offence under section 327, 328 or 329 is liable – (a) on summary conviction, to imprisonment for a term not exceeding six months or to a fine not exceeding the statutory maximum or to both, or (b) on conviction on indictment, to imprisonment for a term not exceeding 14 years or to a fine or to both'. Should the incentive not entice the banker to assist the authorities as opposed to the "big bully" approach – "help me or else". In the author's view, the incentive to assist should be one where the banker is actually rewarded for the assistance. Since it is money that drives a banker to assist the criminal, in the author's view, money can also entice the banker to assist the authorities. Moreover, although it is an offence not to report suspicion or knowledge, it is only punishable if the authorities can prove that the banker knew or should have suspected the laundering. Earlier it was shown that a pool of receivables can be made to look clean thus, making it difficult, if not impossible, for the banker to suspect anything criminal. Thus, unless the banker knows that the pool is of criminal origin and the authorities prove this, only then is the banker punishable. Thus, like all criminals, *a banker only commits an offence if it gets caught.*

In the US, the fight against money laundering is approached differently compared to the UK. In the US, the USA PATRIOT Act created new anti-money laundering requirements for financial institutions, including, for the first time, hedge funds and investment companies. Banks and broker-dealers were already subject to existing anti-money laundering laws, including the *Money Laundering Control Act* 1986 and the *Bank Secrecy Act* 1970. The USA PATRIOT Act amended these laws to add new requirements and to extend existing provisions to other types of financial institutions. Financial institutions that fail to comply with these requirements face severe civil and criminal penalties. § 352 of the USA PATRIOT Act requires a financial institution to implement an "anti money laundering program" that has, at a minimum, the following four requirements:

1. Policies, procedures and controls designed to detect and prevent money laundering;
2. A compliance officer whose role is to oversee the program;
3. Training for employees on how to detect and prevent money laundering;
4. Periodic audits of the "*anti money laundering program*".

It seems that the USA PATRIOT Act differs from the UK legislation in that the US money laundering law is not a "one size fits all" proposition. The POCA 2002 sets out the law which applies to all equally and clearly whereas, in the US, each financial institution creates and has the flexibility to tailor the anti-money laundering law (called an "anti money laundering program") according to its nature by addressing particular risks or vulnerabilities as it sees fit. Financial institutions design their "anti-money laundering program" to implement procedures and policies that can reasonably detect and report activity that may be associated with money laundering.

Each institution will have a tailor made "program" which defines what money laundering is in the context of an institution's operation before setting out how to recognise it and fight it. Thus, it is important to have money laundering detection procedures in order to avoid possible criminal liability which can occur if the financial institution is *wilfully blind* to money laundering that is occurring under its roof.

Once the pool of receivables has been created, the banker then creates the SPV and its administrative operations. Aside from appointing a management team to oversee the SPV's operation, the banker also creates a bank account which will hold, in trust for the SPV, the proceeds of the receivables as they are received from the underlying debtors. The originator will set up a system which isolates the receivables assigned to the SPV from its own assets.

The system is a computer based system which recognises the assigned receivables and places the proceeds received, by wire transfer, into the bank account created for the SPV. This system works with the management company of the SPV so that receivables from the originator pass to the SPV. In other words, the system is the originator's hand that passes the proceeds to the management company, the SPV's receiving hand.

The banker will, thus, be instrumental in setting up the two bank accounts. The "lockbox" account is simply a collection account in which receivables are collected, in trust, for the management company. To save costs the banker usually creates this account internally with instructions to wire transfer the proceeds at the request of the management company or periodically – usually every 30 days.

The management company creates a separate account – a client account – which it uses to receive the proceeds and calculate what payment is made to the investors or how much is invested in new receivables.

The Money Laundering Regulations 2003 (brought about by the provisions of the *Financial Services and Markets Act* 2000 and which give effect to the Second EC Money Laundering Directive) apply to all entities which provide financial services. The regulator, Financial Services Authority, oversees the operation and compliance of these regulations. Aside from the Bank of England, a banker who accepts the proceeds from the receivables is regulated by the FSA because it provides financial services to third parties. The regulations define 'relevant business' to include 'accepting deposits' (s. 2(2)). The regulations thus, also apply to the banker instructed to receive the proceeds from the "lockbox" account.

Part II of the regulations set out the requirement that those regulated must have in place procedures which identify, record and report any action or transaction which is associated with money laundering. Failure to do so results in criminal sanctions.

The MLR2003 uses the words 'business relationship' as the criteria for invoking identification procedures. In short, the banker must as soon as is reasonably practicable know and verify the true identity of the person with whom it is establishing a 'business relationship'. The USA PATRIOT Act requires the banker to (1) verify the identity of the person opening the account to the extent reasonable and practicable; and (2) maintain the records of the information used to verify the person's identity.

The "lockbox" account is open once the banker has taken steps to know its customer. The banker will look at the originator's business operations and identity and recommend to the business accounts team the opening of the "lockbox" account. Since this is an internal operation, trust facilitates the opening of the account, though the business team will verify the identity of the originator. If the "lockbox" account is opened with an external banker then the external banker will verify the identity of the originator. Regardless of what documents are verified for identity purposes, it is not possible to investigate whether the new customer is, in fact, a criminal. For the launderer to have an account opened makes it easier to clean the proceeds of crime thus, would not object to the verification procedures. The management company will open an account, in trust, for the investors. Again, verification procedures will be followed in order to know the management company.

Both the UK and US laws require bankers and employees to file a Suspicious Activity Report (SAR) with an internally appointed money laundering officer. Each bank trains its employees to recognise any money laundering activity. The training teaches the usual signs of laundering activity. Although the employers can only teach to a certain extent how to recognise money laundering, in reality it is difficult to recognise money laundering. Furthermore, filing SARs adds to the daily workload of the banker and the employees, and bankers are careful not to file and investigate a SAR which later appears to be based on misjudgement. In addition to this, customers would not be pleased if a SAR was wrongfully filed and investigated only to discover later that the transaction was, in fact, legitimate.

For the launderer, placing the money into the banking system poses the only real problem. If the proceeds of crime are mingled with legitimate earnings and transferred into a pool of receivables, they can enter the banking system once the "lockbox" account is opened and starts to accept the receivable payments. The stream of funds moving from the originator to the "lockbox" account and then to the management company's account is undertaken by wire transfers which are evidenced by wiring instructions and a sum of money debited from one account and credited into another using a central clearing system.

Where the banker is directly involved in the securitisation of proceeds of crime then the structure and operations will be conducted using the credibility and reputation of the parties involved and a high degree of legitimacy which, the author believes, can mask an inconspicuous securitisation of proceeds of crime. Where the banker is not directly involved then it is possible to bypass the banker's inquiries using manipulated and falsified paperwork and then relying on the credibility and reputation of the parties involved in order to mask an inconspicuous securitisation of proceeds of crime.

4.3 THE CREDIT RATING AGENCY

The receivables are first analysed by the credit rating agency which will test them using worst case scenarios. The credit rating agency will closely analyse the receivables for any credit, structural and legal risks. The assessment of the credit risk is an important task since it seeks to discover the financial strength and credibility of the pool of receivables. A weak pool will certainly affect the security element of the pool. In other words the assessment discovers and verifies the strength of the pool's collateral. The assessment of the structural risk seeks to discover what internal and external effects can cause cashflow and financial hindrances or difficulties. The legal risk is assessed to ensure that the securitisation is structured correctly from a legal perspective and that the parties involved are protected from internal and external threats. For example, to ensure that creditors and debtors cannot cause hindrances or difficulties for the SPV or the investors. The testing scenarios are designed to consider only those effects which can directly or indirectly affect the cashflow and collateral of the receivables. The scenarios used for testing test the behavioural pattern and the predicted pattern of the cashflow deriving from the receivables under varying financial circumstances.

In practice, the rating agency will look at the isolated pool and work out the contents and value before inputting certain data into their systems – data such as type of assets, life expectancy, financial information (such as interest rates) and approximate size of the pool are all entered and computer software runs a series of testing scenarios. The results are produced which then become the basis for determining the level of credit enhancement and amendments.

Since dirty money mingled with clean money does not cause any detrimental financial effect upon, or reduces or impacts upon, the cashflow or value and collateral of the pool, the criteria under the testing scenarios does not consider the effects of dirty money mingled with clean money. Moreover, dirty money mingled with clean money does not "dirty" the value and collateral of the pool – the dirty money actually gets cleaned.

But is it possible for the rating agency to recognise proceeds of crime during the testing? The author contacted the leading rating agencies and posed the question:

> Is it possible for a credit rating agency to recognise or detect proceeds of crime which may have been mingled with legitimate earnings in an isolated pool of receivables? If so, how?

The author approached this part of the research with the view that since the receivables are tested (using "worst case scenarios") for reliability and strength, proceeds of crime that may have been mingled with legitimate earnings would not affect the reliability and strength of the pool – dirty money does not affect the value and collateral of the pool. Thus, the testing scenarios are designed only to consider those factors which would affect reliability and strength. A few of the rating agencies were helpful only to a certain extent given that the author was inquiring into the shortfalls and vulnerabilities of the rating criteria. Moody's, London, warned that, 'many agencies would be reluctant to give a detailed answer because you are exposing vulnerabilities of an established and trusted mechanism that adds credibility to a securitisation programme' (interview: 5th June, 2003). They were not prepared to answer the question directly since they felt, 'such an answer would seriously undermine their rating criteria'. Aside from the warning and reluctance to assist in answering the question, they did say that, 'they are continuously monitoring their rating criteria and undertaking research into any shortfalls of their criteria and analysis'.

However, Standard & Poor's, London, kindly responded to the author's question:

> 'Generally speaking when we are looking at a portfolio, let's use credit cards as an example, the portfolio is clearly open to fraud and crime at many levels; money laundering, fraudulent applications, fraudulent transactions, fraudulent bank staff etc. Any purchased portfolio carries the same risks that the portfolio had in the first place when it was on the originator's balance sheet.
>
> The originator will historically have been subjected to these events and would display this data either directly in their default data or via separate reporting on fraud and other losses. When we are analysing a transaction we review this historic data and stress this at the various rating levels being considered for the issued bonds. The stresses are the same as would be used for a standard default caused by non-payment etc.

> So to answer your question directly, no we don't have the ability to detect the fraud/crime being experienced but the originator/servicer does. They will identify these actions in their normal way and report accordingly. Historic data has been reviewed as part of the rating process and stressed accordingly.'

The reply makes a number of interesting points.

i. The onus is on the originator to detect any fraud or crime that may allow it to mingle dirty money with clean money. This onus may stem from The *Proceeds of Crime Act* 2002 which tackles money laundering.
ii. The originator's ability to detect fraud/crime is obvious since it is in control of its own operations and documents. It can create documents according to how it wishes any third party to read them.
iii. The rating agency relies largely what the originator informs it with regards to any risks associated with fraud – 'money laundering, fraudulent applications, fraudulent transactions, fraudulent bank staff etc'. Fraudulent applications are those which potential obligors are likely to make in order to gain from the originator. It is difficult for the originator to truly estimate the level of false applications made which have passed its eligibility criteria. Thus, the originator would aim to keep this estimate very low so as not to expose and highlight any vulnerability of its eligibility criteria and its operations. The same would apply to reporting any fraudulent staff and transactions which may have passed its criteria and entered its systems. The originator will aim to ensure that its business operations are not viewed as easy targets for fraud/crime since this will inevitably affect its credibility and may impact on its credit rating. However, the rating agency would not be impressed if the originator declared a complete fraud free estimate since the agency knows through experience that fraud/crime can bypass many of the hurdles put in place to keep dirty money out.
iv. The rating agency relies largely on the information given by the originator. Thus, if the originator declares that regardless of a tight eligibility and verification criteria, the pool will contain 1,000,000,000 receivables of which 10 can be said to be fraud/crime based, the rating agency will use this figure in the testing scenario since there is a risk that the criminal is more likely to default on the receivables and generate further receivables which are non-paying.

v. The only consideration associated with fraud/crime is that which derives from the possibility that the pool may contain fraudulent applications which will generate non-paying receivables. It is understandable why these receivables would need to be weeded out or at least be covered for since these are receivables which are as good as guaranteed defaulting receivables. More importantly, these receivables will affect the cashflow, value and collateral of the pool whereas, proceeds of crime do not affect such cashflow, value and collateral. The receivables are actually generating cashflow (regardless of source) when the launderer pays monies (supported by false documents) into the financial system.

The answer is given in a particular context – whether credit card receivables can be checked for abuse and what response is invoked from the rating agency. However, how would the credit rating agency react if the receivables were generated where the originator could verify the legitimacy or possible fraud? The answer mentioned that the originator of credit card receivables would have in place certain eligibility and verification procedures which would weed out fraudulent applications and potential non-paying receivables. How the originator does this is taken into consideration when analysing the pool so that all risks can be accounted for. The rating agency admits that they are in a position where they are largely reliant on what the originator of credit card receivables would inform them. However, what if the receivables were not credit card receivables which could be verified or where the fraud risk could not be measured?

For example, trade receivables generated by the originator through business operations. These receivables would be generated by contracts which do not necessarily have an eligibility or verification criteria. The originator would have its own internal checks which it would make before granting credit or entering into a business relationship. However, whether the other party is capable of committing fraud would be beyond consideration since the originator would only do business once comfort and confidence surfaces. And if the contract failed to generate the receivable the originator can recover by claiming for a breach of contract.

It would seem that the rating agency would look to what internal procedures the originator of trade receivables has in order to show that its trade contracts are in fact fraud-free and will generate the receivables. The credit control checks would be examined by the rating agency in order to work out whether the originator is granting credit in a prudent and cautious manner so as not to generate non-paying receivables.

It would also seem that the rating agency would ask the originator what internal checks it does in order to protect itself from generating non-paying receivables through fraud. Regardless of assets type, originators would have some level of checks to deter criminals from generating non-paying receivables. But what if the originator merely uses the pool of receivables as a placement and layering technique to clean dirty money? In other words, if the originator wanted to mingle illegitimate proceeds with receivables and claim to have in place acceptable internal checks and controls, can the rating agency consider any risk of fraud beyond what is measurable? The answer would seem to be no. The rating agency will rely on what it is informed by the originator – thus, if the originator mingles proceeds of crime with receivables and claims that the pool has undergone its internal checks and controls, it seems that the rating agency would gain comfort from this without making further inquiries – a fact confirmed by Standard and Poor's.

Another helpful response which strengthens the author's theory is from another leading rating agency (Weiss Rating),

> 'The only way a credit rating agency can detect fraudulent receivables is by analyzing each of the underlying assets in the pool (each receivable held by the SPV).
>
> Very similar to a collateral audit, typically, credit rating agencies will measure the quality of the receivables pool as a whole, and will not measure the quality of each receivable in the pool. For example, when looking at an A/R aging report, we measure the percentage of receivables which are not past due, not each receivable which is current. Receivables in a securitization program will not be individually examined.
>
> In order to avoid fraudulent receivables in a securitization program, the following due diligence questions have proven helpful: What is the basis of the receivable? Where is it being generated from?'

This, again, makes some interesting points:

i. It confirms what the author argues that in order to detect proceeds of crime the rating agency would need to investigate each individual receivable. This, in practice, is far from reality given the size of a typical pool and the time restraints within which parties are operating.
ii. Part of the credit analysis involves what is known as a "collateral audit" which in essence measures the quality of the pool. Note that the agency will

measure the quality of the pool as a whole and not measure the quality by dissecting the pool to measure each individual receivable.

iii. The rating agency would exercise due diligence by inquiring into the origin of the pool. But the previous quote has confirmed that 'we don't have the ability to detect the fraud/crime being experienced but the originator/servicer does'. The rating agency relies on the internal checks conducted by the originator. Thus, bogus paperwork can provide evidence to cover receivables which have an illegal origin and as long as the originator demonstrates effective internal checks, the rating agency has conducted due diligence. Unfortunately, the rating agency is limited as to how it can inquire into the pool of receivables and given that the financial world relies very much on professional trust, it would seem that it is possible to exploit what can now be seen as vulnerabilities and shortfalls.

Moody's, London was also approached again for their reaction and comments (interview: 20th June, 2003). The author presented his view regarding the vulnerabilities and shortfalls of the commonalities in the rating criteria, and even discreetly summarised the evidence given by Standard & Poor's and Weiss Rating. They still declined to comment or assist in any way whatsoever. The general impression given was that this was a sensitive issue for them given that Moody's holds a worldwide reputation for rating securitisation transactions. It is understandable why such reluctance would be used to answer questions designed to reveal a shortfall or vulnerability. Credit rating is a valuable tool which drives the credibility and reliability of the financial system and any vulnerability can affect levels of investor and professional confidence. It seems to safeguard confidence levels. A rating agency would be reluctant to expose certain vulnerabilities even though such vulnerabilities are beyond their control. Standard & Poor's welcomed the questioning and even added that the author's revelations have prompted Standard & Poor's to research into this area of concern.

In conclusion, based upon the facts that firstly, investigating the origin of each real and (purported) legitimate receivable is beyond the instructions and ability of the credit rating agency, secondly, given that invoices and contracts can be invented to disguise proceeds of crime, thirdly, it is difficult for the credit rating agency to create a system which can investigate the true origin of each receivable, and finally, that dirty money cannot cause any detriment or affect the cashflow, value and collateral of the pool, the author concludes that proceeds of crime can inconspicuously slide through or bypass the credit rating agency's testing scenarios and enter the placement stage of the laundering process.

The *Proceeds of Crime Act* 2003 (POCA) does, however, require professionals to assist authorities in tackling and reducing money laundering. Section 327 provides,

> (1) A person commits an offence if he -
>
> (a) conceals criminal property;
>
> …
>
> (3) Concealing or disguising criminal property includes concealing or disguising its nature, source, location, disposition, movement or ownership or any rights with respect to it.

This is only effective against the credit rating agency if the testing scenarios and the investigations into the nature and source of the receivables (as disclosed by the SPV, the originator and the investment bankers) show that such receivables are or can be suspected to be proceeds of crime. But the research has demonstrated how proceeds of crime can inconspicuously slide through or bypass the criteria of the testing scenarios thus, the credit rating agency is under no obligation to report under s.338 what it does not know or suspect. Nor, is it safe to say that the rating agency should have reasonable grounds for knowing or suspecting that receivables may be the proceeds of crime since their duty is to test the value and collateral of the receivables and investigate any effects on the cashflow.

Dirty money mingled with clean money does not get dirty but gets cleaned. It seems the provisions are drafted to reflect a scenario at a particular point in time in which it is possible or reasonably possible for an entity to investigate and then report that a transaction is creating or will create, or certain funds are the proceeds of crime. The credit rating agency's duty is confined to giving a short opinion relating to what it sees as the credit standing of the receivables. Its duties occur before the scenario reflected in the provisions of the POCA occurs and furthermore, its findings are based partly on what it is informed by the originator's bankers, accountants, auditors, lawyers and the SPV's directors, trustees, accountants, bankers and lawyers.

Section 328 POCA is also triggered but is ineffective against the credit rating agency. Section 328 provides,

> (1) A person commits an offence if he enters into or becomes concerned in an arrangement which he knows or suspects facilitates (by whatever means) the

> acquisition, retention, use or control of criminal property by or on behalf of another person.

The credit rating agency becomes concerned in a securitisation arrangement but cannot know or suspect, for reasons already given, that it is dealing with proceeds of crime. The *Money Laundering Regulations* 2003 also impose on professionals the obligation to assist authorities to tackle and reduce money laundering. In short, these regulations do not apply to a credit rating agency – the regulations only apply to a 'relevant business' as defined by Regulation 2 of the MLR 2003, and such definition does not catch the rating agency.

4.4 THE ACCOUNTANT

The accountant is also a key player in any securitisation transaction. The originator's accountant presents the financial statements which the banker uses in structuring the transaction. The accountant can only document what the originator informs it – thus, whether an illegal activity is undertaken by the originator, evidence of this can only surface if the originator presents documents to the accountant which raises suspicion. Note, that the originator is subjected to an annual audit (usually by the same firm of accountants.) During this audit it may be possible to calculate a trail of illegal activity, however, given the inconspicuous sophistication of financial crime, false documents can be manufactured to support certain opinions in the financial statements.

The accountant is placed in a tricky position – on the one hand it must report anything which raises suspicion yet conversely, it owes a duty of confidentiality to its client. However, it seems the solution is to report the suspicion given that it is illegal not to do so, and then plead the statutory provision to report suspicion in the event of any legal action for breaching client confidentiality. Whether this has any practical effect can be gauged from Rosalind Wright CB, Director, Serious Fraud Office (lecture: 12th September, 2002),

> 'The number of suspicious transaction reports (STRs) last year [2001] amounted to 21,251, up 13,000 from the year before…The number of STRs from accountants was… 0.35%, half the amount reported in 1998. NCIS say that motoring organisations, such as the AA and the RAC have submitted more STRs than accountants have in recent years'.

The figures reported (perhaps dated at the time of writing) do, however, show the tricky position an accountant is placed in when dealing with suspicion. It seems that client confidentiality carries more weight given the commercial and financial implications that are involved. Yet this does not mean that an accountant would knowingly breach reporting provisions. It is a decision which only the accountant can make based upon what evidence and suspicion has surfaced. Yet this point indicates a sensitive issue and another vulnerability of the system within which securitisation lives.

The accountant is also instructed to handle the financial affairs of the SPV. The management company usually instructs the originator's accountant since firstly, it is familiar with the receivables in question and secondly, it is cost effective. Thus, the SPV's accountant undertakes to document the activities of the pool of receivables throughout its life. As receivables are received they are recorded by the management company and these records are passed on to the accountant.

A major part of the accountant's task is to undertake a "collateral audit" which is a sieve like audit that weeds out any non-performing or defaulting receivables from the pool (Deloitte and Touché, New York, interview: 23rd June, 2003). This is imperative since any opinions given by the credit rating agency would have included the assumption that non-performing and defaulting receivables would be weeded out at the earliest opportunity so that the collateral value of the pool does not fall.

This "collateral audit" involves analysing the pool's contents for changes in performance and levels of liquidity. For example, a pool of credit card receivables are likely to materialise at a faster pace than mortgages – the behaviour is more likely to be different. Mortgage receivables are long-term whereas, credit card receivables are short-term – the payment pattern is different. The pool of credit card receivables needs to be monitored closely so that non-performing or defaulting receivables can be weeded out and replaced (through credit enhancement – reinvestment) as soon as possible so that the pool's collateral and cashflow is not affected.

The frequency of this audit depends largely on the term and payment pattern of the receivables. Long term receivables are usually monitored monthly or quarterly – a long-term receivable becomes non-performing or defaulting when two or more payments have not materialised. Conversely, short-term receivables become non-performing or defaulting when their materialisation falls short of what was expected. A pool of short-term receivables is expected to materialise at a predicted pace and generate cashflow in par with the interest and principal payments due on the issued bonds.

The "collateral audit" only seeks to weed out non-performing and defaulting receivables – it is not designed to weed out proceeds of crime or other suspicious looking receivables (as confirmed by PriceWaterhouseCoopers, London, interview: 30th June, 2003),

> 'A collateral audit, which is also referred to as a pool audit, is simply a periodic process that helps the pool maintain its financial strength. It is, as you say, not designed to catch illegitimate receivables…and I agree with you when you say illegitimate receivables are more likely to materialise into cashflow than legitimate receivables'.

Thus, any suspicious looking receivables are weeded out because they are non-performing or defaulting, and not because they may be proceeds of crime. Interestingly, receivables which are in fact proceeds of crime are more likely to materialise and generate the income evidenced by manufactured paperwork. The launderer will want to place the proceeds of crime into the financial system. Thus, in a pool of receivables which contains proceeds of crime which will certainly not default or be weeded out for non-performance, does the "collateral audit" fail to detect proceeds of crime? It seems it does.

Both PriceWaterhouseCoopers and Deloitte & Touché recognised the author's view in relation to the shortfall of a "collateral audit" but were not willing to admit that they are aware of receivables being mingled deceptively with proceeds of crime since this would then put into question their ability to conduct effective due diligence. A forensic accountant at Deloitte & Touché, London, however, admitted that (*paraphrased*), '[he/she] would not be surprised if [a] firm unknowingly facilitated proceeds of crime to be cleaned in the manner [the author] describes' (interview: 8th July, 2003). The Transaction Services team at KPMG, London, were also approached for their view but their view was not forthcoming. A member of the team said 'they would email the author with their view' (interview: 8th July, 2003) but after four follow up requests the author concluded that they were reluctant to give any assistance. The Transaction Services team at KPMG, New York, said that the author should communicate with their press office – their press office did not understand the issue put to them and replied that I should communicate with a professional at KPMG (interview: 9th July, 2003).

According to PriceWaterhouseCoopers, London (interview: 30th June, 2003) aside from the "collateral audit" there is no other analysis undertaken by the accountant which may detect proceeds of crime in a pool, unless it is 'frozen and investigated',

> 'In order to discover possible illegitimate receivables we would have to conduct a thorough investigation using our forensic team and technology…this is a time consuming exercise which can only be done once the pool is frozen and investigated. Tracking the movements of a changing pool is difficult especially in a global financial system'.

Another task undertaken by the accountant is to document the pool's behaviour in annual accounts – how much income was received and how much of this was paid out to investors.

5. CONCLUSION

The essence and purpose of this chapter and this thesis is to expand existing knowledge with an original contribution. Such contribution has been made, in part, using empirical research to test the hypothesis: *if the activities behind the Enron scandal are related to the vulnerabilities of a securitisation transaction, then such vulnerabilities may be exploited to the extent that a securitisation transaction may facilitate money laundering.* With a good practical understanding of securitisation, and the assistance of the professionals mentioned above, the author has tested and affirmatively answered the hypothesis, such that the research has revealed certain vulnerabilities within a securitisation transaction, vulnerabilities which may have played a part in the activities behind the Enron scandal.

Financial crime is evolving everyday in response to the changes in law and regulation. The Enron scandal has shown how accountants are clever enough to perform magic in financial documents and how lawyers are clever enough to defend themselves. It seems the authorities are too busy chasing the big known criminals or suspects and often overlook the inconspicuous criminal hidden behind a fog of legitimacy, while the investors, too busy trying to keep afloat in a fluctuating economy, overlook certain detail and fail to read between the lines. Against such reality is it safe to say we live in a world where a financial crime is only committed if and when the criminal gets caught?

> 'Money laundering can only take place where there are sophisticated professionals, such as lawyers, accountants and bankers who are willing to be actively engaged in criminal acts or simply shut their eyes to the truth'.
> (Rosalind Wright CB, Director, Serious Fraud Office, lecture: 10th September, 2001)

CHAPTER 7 SECURITISATION AND WHITE COLLAR CRIME

This final chapter of the work explores the nature of white collar crime as it relates to securitisation. The preceding chapter examined money laundering in the context of securitisation which involved empirical research demonstrating how securitisation can potentially be manipulated to launder proceeds of crime. As a follow on from that conclusion this chapter, based on certain traditional theories of white collar crime, will seek to answer: (1) what are the reasons for those involved to take advantage of this vulnerability and commit white collar crime? (2) who is likely to engage in white collar crime?

1. WHAT IS WHITE COLLAR CRIME?

The term “white collar crime” was invented by Professor Edwin Sutherland (Sutherland, 1949: 3-4) in order to point out weaknesses in typical crime theories that considered “social pathology” as the primary explanation behind criminal behaviour. Prior to Sutherland, criminal theory and research had focused on the lower classes with confined discussion so that conclusions reached would depict a nexus between criminal behaviour and the status of the lower classes. For example, the works inspired by the Chicago School of Sociology: McKay (1930); later Shaw and McKay (1942); and those of Robert Merton (1938). The confinement and limitations of the research were, to a certain extent, intentional since at that time, and more importantly before Sutherland, the general accepted theory was that there is a nexus between low status and criminality.

Sutherland researched further the notion and nexus of status and criminality – his theory on white collar crime was aimed to challenge existing theories and cast doubt on the notion that poverty, disturbed home life, and abnormal personalities are the root causes of crime. He introduced the notion of white collar crime in an effort to develop a general crime theory that would adequately explain crime in both upper and lower classes. Sutherland argued that members of society occupying positions of privilege and status were just as likely to commit crimes as those from the lower classes. Sutherland defined white collar crime as, ‘crime committed by a person of respectability and high social status in the course of his occupation’ (Sutherland, 1949: 7).

This definition attracted much attention – it was supported and developed yet also heavily criticised for being vague, inaccurate and wholly inappropriate to the extent that ‘if Sutherland merited a Nobel prize, as Mannheim thought, for pioneering this field of study, he certainly did not deserve it for the clarity or serviceableness of his definition' (Nelken, 1996: 123). So where did Sutherland go wrong?

Firstly, what should be the defining feature of white collar crime – the occupational nature of the activities or the social characteristics and status of the offender? This poses the immediate problem of how "high social status" or "respectability" are to be defined. Where is the line to be drawn in the occupational hierarchy? Sutherland did not define "high social status" thus, his definition raises a number of possible levels of high status – the aristocracy, the upper classes, the middle classes and those who have benefited from social mobility and opportunities. Sutherland's definition, it seems, reflects the type of person who was capable of committing white collar crime at the time when Sutherland composed his understanding of the subject – 'a person of respectability and high social status'.

At the time when this definition was composed, those who held respect and high social status were more likely than not to have been well educated. Thus, these persons it seems would have enjoyed employment which would have been considered as more skilled and respectable than those undertaken by the lower classes. From Sutherland's explanation of the subject it can be reasonably deduced that white collar crime, as Sutherland perceived it, was only committable by the well educated – an intellectually demanding crime. The method of committing the crime was connected with employment – 'in the course of his occupation'. It is true that white collar crime is usually associated with the crimes of senior management and executives but customers and employers can also be defrauded by junior personnel, and secretaries can also sell inside information – occupational roles can be abused irrespective of status (Mars, 1982: 45-46). Thus, does Sutherland's definition only reflect white collar crime at the time when he composed it or has it withstood the passage of time? It seems his definition is now somewhat dated.

Secondly, Sutherland provides that white collar crime is committable through occupation which raises the question: did he perceive that the criminal commits the crime during office hours only? Did he not consider whether white collar crime is possible out of office hours and within a personal capacity? It seems that Sutherland limited his discussion of the subject to the social and occupational circumstances at the time of writing. The author agrees that Sutherland, in the context and circumstances at the time, originated an interesting theory but with time and evolution it is now of limited significance. Although Sutherland discussed major corporations in his research (which he did not name for fear of being sued for libel), he failed to recognise that small businesses can also be responsible for similar offences. One view states that 'white collar crime is not a disease of large businesses…that many medium size firms, partnerships and single owner proprietors commit white collar crime' (Levi and Pithouse, 1991: 56). For example, consumers can be "ripped off" by local corner shops, market stalls or large manufacturers, and environmental pollution or safety offences in the workplace can be associated with "cowboy" operators or large multinational conglomerates.

Professor James Coleman expanded on Sutherland's work by defining white collar crime as, 'a violation of the law committed by a person or group of persons in the course of an otherwise respected and legitimate occupation or financial activity' (1989: 24). This definition broadened Sutherland's definition to include individuals of all social classes and financial crimes as well as both civil and criminal violations. Coleman split white collar crime into "organisational" and "occupational" crime and emphasised the difference between "individual" and "corporate perpetrators". According to Coleman, "organisational crime" includes, among others, fraud, tax evasion, unfair competition practices, price fixing, unsafe production, bribery and corruption. In contrast, "occupational crime" includes crimes against an employer by an employee, embezzlement, computer crime, acceptance of corporate bribes, crimes against the public, and crimes against the government.

But Coleman's definition adds 'financial activity' to clarify the methods used to commit white collar crime. His definition includes an important point that white collar crime is 'committed by a person or group of persons in the course of an otherwise respected and legitimate occupation or financial activity'. He has separated how the crime can be committed – individually or as part of a group.

Further, the wording 'in the course of an otherwise respected and legitimate occupation or financial activity' is interesting in that Coleman perceives white collar crime as an offence committed outside the scope or boundary of a respected and legitimate occupation or financial activity. The other aforementioned definitions do not make this point but simply state that white collar crime is committed in the course of an occupation. Coleman goes further to say that anything done within the scope or according to the rules is acceptable but once the criminal act goes beyond this it then should be interpreted as a white collar crime, a view shared by Bartol (1999).

Another definition, in Nelken's view (1996: 364), inspired by the Sutherland school of thought is that of Clarke, 'business crime, however, in the sense it is used here, covers a much wider range of misconduct, which may be none the less damaging and otherwise undesirable, resulting from duress, incompetence, negligence, lack of training, lack of clarity in the rules, opportunism, technical infraction, or sheer muddle-headedness, rather than calculated deceit motivated by greed'. Clarke's view of white collar crime is that it should be, firstly, called "business crime" because it is a crime usually associated with business operations, and secondly, that it is not a crime based upon deceit but an act that is caused by an individual's or its employer's failure to conduct business in a proper manner.

In response, firstly, why would an act based upon the failure to conduct business in a proper manner be a crime? The legal view is that it is more connected with being a civil wrong (if it causes a loss) than a crime. Secondly, Clarke fails to consider that a crime committed in the workplace does not always involve deceit – theft and insider trading are examples of crimes where deceit is not part of the act. Finally, why call his research "business crime" when he does not view white collar crimes committed in the workplace as crimes?

Professors Marshall Clinard and Richard Quinney (cited in Poveda, 1994: 2) offered a definition consisting of two categories: "occupational crime" and "corporate crime", with occupational crime being similar to abuse of trust, and corporate crime resembling business crime. More specifically, the authors explain occupational crime as consisting of, 'offences committed by individuals for themselves in the course of their occupations and the offences of employees against their employers'. In contrast, corporate crime is defined as, 'the offences committed by corporate officials for the corporation and the offences of the corporation itself'.

This definition limits white collar crime to offences which a criminal commits for him/herself – a self gaining crime. It is true that a criminal undertakes criminal behaviour to gain but this definition excludes those crimes which the criminal may be influenced to undertake on another's behalf with no self gain. Further, another limitation placed in the definition is that it covers offences which an employee will commit against the employer – white collar crime can be committed against any person or organisation.

Another definition by Edelhertz (cited by Nelken, 1996) of white collar crime focuses more on incorporating elements of fraud into the definition of white collar crime, 'an illegal act or series of illegal acts committed by non-physical means and by concealment or guile, to obtain money or property, to avoid the payment or loss of money or property, or to obtain business or personal advantage'. The definition given by Edelhertz should be seen as a giant leap towards an appropriate definition that reflects white collar crime. Edelhertz incorporated the element of fraud into the definition and describes white collar crime with more colour. Firstly, he separated criminal acts into physical and non-physical and stated that white collar crime is the latter. Secondly, he recognised that white collar crime can be a single act or part of a series – it can be committed as a one-off or a repeated act. Thirdly, he introduced the *mens rea* into the definition in that the crime is committable 'by concealment or guile' – the criminal is aware of the wrongdoing at the outset of the crime. Fourthly, and interestingly he introduced a description of the fruits of the crime – to gain something or prevent loss that is beyond what is normal under the circumstances – 'to obtain money or property, to avoid the payment or loss of money or property, or to obtain business or personal advantage'.

These newer definitions, however, remove what historically was the major feature of white collar crime – its association with high social status. They also make the contents of white collar crime extremely large, incorporating also acts usually associated with "blue-collar" occupations.

On the other hand the definition of white collar crime now has become blurred and detracts from what white collar crime originally was. To a certain extent this gives room to develop or refine individual definitions of what white collar crime is. For example, white collar crime can be seen as a wrong, judged by criminal law, committed by an individual in the course of their employment and/or which breaches a relationship of trust to further their or the employer's interests or gains. It should be labelled as white collar crime if it infringes criminal law. It should be renamed white collar wrong if it also infringes civil rights.

This definition is perhaps more workable in the context of securitisation since it also incorporates the additional requirement that there may be a relationship of trust between the wrongdoer and the victim. Sutherland's definition is too dated and wholly inappropriate for securitisation purposes since it limits the offenders to high status holders. Coleman's definition is useful but limits itself to only covering criminal acts – it does not cover relationships of trust such as fiduciary duties. Clarke's definition is nothing more than listing individual or corporate incompetencies. Clinard and Quinney, although split white collar crime into two categories, still only deal with offences which arguably implies that white collar crime does not include breaches of trust – it is a breach of criminal law only. Professor Edelhertz interestingly uses the words 'concealment or guile' to depict that the criminal can compose a scheme which can mask an illegal act. His definition resembles money laundering. However, it is debatable whether such scheme to mask an illegal act breaches a relationship of trust. The *prima facia* view is that his wording does not include a relationship of trust, however, does inspire debate as to how 'concealment' can be defined. A scheme to mask an illegal act will involve more than one party which can imply that there is also a relationship of trust between them.

The breach of trust is an essential requirement since it expands the recognition of an offence or wrong to include acts which fall outside of in the course of employment. The wording "in course of employment" firstly, implies that there must be a contract between the employee and the employer (or it can a contract for services, i.e., a contractor, or an external party who is employed or under a contract of services which are then provided to the firm concerned) – this is vital where the employee offends against the employer. Secondly, it implies that only those acts are covered which are done during office hours or the period during which the criminal is an "employee".

Thirdly, it does not cover any acts done when employment is terminated – for example it does not stop an employee selling secrets when he/she is fired. Finally, it does not covers acts done where the criminal takes advantage of his/her or the employers reputation, credibility and trust within the industry.

Incorporating an express breach of trust requirement deals with all these shortfalls – an employment contract between the criminal and the victim is not a prerequisite for a relationship of trust – it covers all acts done outside of office hours or any other period where the criminal is not an "employee" – it covers for a reasonable period of time all acts after employment is terminated – it covers acts done which take advantage of his/her or the employers reputation, credibility and trust within the industry.

Such a breach of trust requirement is essential since the professionals who abuse securitisation will do so by using the reputation, credibility and trust it enjoys within its industry. For example, the lawyers have no relationship by contract with the investors but nevertheless have a relationship of trust implied from the contract the lawyer has with the SPV – the investors can sue for (professional) negligence regardless of any contractual nexus.

2. THEORIES OF WHITE COLLAR CRIME

Given the large body of theoretical literature that exists in this field, namely, traditional, modern and post-modern, the following highlights the traditional theories of white collar crime.

1. Social Learning Theory

Sutherland developed the theory of "differential association" in an effort to explain crime across the social strata. This theory proposes that crime is a behaviour learnt in "intimate personal groups" and is a function of contact with criminal and non-criminal patterns of behaviour. Further, the theory suggests that an individual will acquire the behavioural/cultural patterns that surround him/her unless he/she is exposed to an alternative or conflicting behaviour. In that case, criminal behaviour will emerge only if or when criminal associations exceed non-criminal ones (Croall, 1992).

Finally, criminal behaviour is viewed as a function of frequency, duration, priority, and intensity of negative associations (Povenda, 1994: 56). Thus, "intelligent community" (a term used to describe those who are educated and live within the accepted social morals yet may be vulnerable to falling short of social morals) employees who work alongside peers engaged in employee theft, security violations, or treason may view the behaviour as an acceptable option with limited risk of detection or punishment.

In order to account for group, community, and national differences in crime, Sutherland included concepts of "culture conflict and social disorganization". In other words, Sutherland suggested that communities with a higher level of social disorganisation experience higher crime rates, with social disorganisation taking the form of "anomie" (a sense of normlessness or uncertainty about right/wrong) or "culture conflict" where competing norms dictate different behaviours in the same situation.

2. Anomie/Strain Theory

Although "strain theory" was formulated to explain lower class crime and urban gang delinquency, this theory was subsequently applied as an alternative criminological theory to the explanation of white collar crime. In its original form, strain was viewed as the result of the 'unequal distribution of means to achieve success' (Nelken, 1996: 157). This theory was originally inspired by Merton's *theory on anomie* which proposed that white collar crime was an innovative response by business personnel to the strain of surviving in difficult times (Gottfredson and Hirschi, 1990: 78). Personnel would cut corners in order to maintain levels of profitability which criminological theory described and justified as "strain". This theory further proposes that strain – limited access to legitimate means of advancement – fosters crime as an alternate path to survival.

In its application to white collar crime, this theory suggests that the competitive marketplace creates a similar kind of strain, which in turn leads individuals to engage in questionable behaviour in the pursuit of profits, market share, acquisition of desired information, and/or individual advancement.

3. Rationalisation and Control Theory

This theory provides that deviance results when individuals can rationalise their actions and avoid the sense of right and wrong about their behaviour. Rationalisation (or justification or neutralisation) is seen as the means by which individuals "neutralise" their commitment to conventional values and permit themselves to engage in questionable behaviour without seeing themselves as criminal or deviant (Duffield and Grabowsky, 1984). According to this theory, “neutralisation” occurs prior to the commission of the act in question and in fact serves as part of the motivation for the act. For example, employee theft may be motivated and neutralised by the belief that occasional workplace "theft" is just compensation for a meager salary and benefits package.

Neutralisation theory helps to understand the individual and situational causes of crime, as neutralisation allows for the commission of an offence in the face of and regardless of contradictory normative expectations. Criminological research, for example, Coleman (1989) has revealed several neutralisations, including the belief that the action was not criminal because it did not hurt/damage the victim; represented borrowing with the intent to return/repay the debt; was necessary for survival within a competitive economy; was common practice; the employee was entitled to such fringe benefits or compensatory income.

“Control theory” asserts the importance of interpersonal bonds in buffering individuals against criminal involvement. More specifically, this theory provides that crime is a ‘human drive that will emerge unless internal drives are curbed/channelled by external social forces’ (Coleman, 1989: 79). Righteousness is maintained by bonds to society, family, peers, church, school, and neighbourhood. As these bonds weaken, the risk of involvement in criminal behaviour increases.

4. Integrationist Theory

This theory focuses on the "culture of competition" as the primary source of motivation for white collar crime. According to Coleman (1989: 203-204) the culture of competition is ‘characterised by an intense desire for wealth and success and an overwhelming fear of failure’. Corporations within a capitalistic culture encourage the ‘values, attitudes, and personality structures conducive to white collar crime’ and thus, ‘ensure an ample supply of potential violators’. In some instances, ‘occupational positions virtually force their occupants to violate the law in order to succeed’. Thus, individuals with hard-driving personalities that value success above all else are likely to seek out competitive corporate environments, enjoy career advancement, and possess a greater risk for involvement in criminal activities in the conduct of their work duties.

Coleman asserts that the fear of failure/loss of status is a primary motivator for white collar criminals and offers three necessary conditions for the commission of white collar crime – motivation, ability to neutralise ethical standards that inhibit criminal behaviour, and access to criminal opportunities. Coleman further believes that financial motivations are the trigger for white collar crime involvement. He notes that a bulk of white collar crime is motivated by the fear of losing one's status and success and not just the greedy desire to acquire wealth without work.

Further, Coleman proposes that the distribution of opportunities for occupational crime is largely determined by the legal system and its approach to the prosecution of crime, in other words, lax sentencing of white collar crimes sends a message of tolerance thus, increasing perceived opportunity among potential criminals.

3. Theories and Securitisation

So how do these traditional theories of criminological behaviour apply to a comparatively new subject like securitisation? What motivates the originator and the professionals involved to undertake a white collar crime? As stated in the preceding chapter, securitisation is exposed to vulnerabilities in the financial system within which it lives.

The preceding chapter demonstrated one key financial crime which securitisation potentially facilitates, namely, money laundering. This vulnerability can be at different levels within the financial system and can either hide behind a mask of legitimacy, alternatively, be overlooked due to the trust, reputation and credibility that foster relations and transactions within the financial community. The theories of white collar crime apply to behaviours which exist within a professional environment and seek to provide some justification for such behaviours. There are also theories which seek to analyse the psychological reasons behind white collar crime, however, this discussion shall only focus on linking the mentioned theories with potential crimes involving securitisation.

Securitisation is a financing technique which is perhaps more technical and involved than its alternatives like equity offerings. There are two key transactions which materialise with the assistance of numerous professionals. The discussion and empirical research in the preceding chapter demonstrated how the originator can launder proceeds of crime – mingling them with legitimate receivables in order to place them into the financial system.

4. WHY WOULD THE ORIGINATOR ABUSE SECURITISATION?

It seems that Sutherland's theory on "differential association" can assist to provide some justification for the criminal originator's desire to use and abuse a legitimate financing technique to launder proceeds of crime. Using Sutherland's theory of differential association criminal behaviour is learnt – individuals will learn how to offend in the context of their criminal associations (Croall, 1992: 89). For example, a graduate may grow up in a family environment that allows a low risk of learning how to offend. During this period the graduate is exposed to good ethics and practice. However, upon entering employment he finds that many of his colleagues are corrupt and engaging white collar crime. These associations coupled with the need to establish a customary lifestyle may override the honest way of life which he has hitherto learnt.

Sutherland further proposed that the criminal is more likely to commit a crime unless he/she is exposed to an alternative or conflicting behaviour. In other words and in the context of securitisation, the originator will desire to launder the proceeds of crime unless it is faced with or is influenced by legitimate behaviour. However, this is not entirely true when applied to an originator seeking to abuse securitisation.

Money laundering occurs when the financial system is used and abused to such an extent that dirty money is cleaned and given a legitimate appearance. The launderer is motivated to do this by his desire to keep the money generated from the illegal activities. Tougher rules also motivate the launderer to become more adaptable, evasive, and professional looking. The author believes such motivations would certainly drive the commission of the offence regardless of any exposure to an alternative or conflicting behaviour. Levi and Pithouse (1991: 122) believe that regulations, although attempt to hinder or eliminate criminality, also act as a motivating factor which allows the criminal to test his/her ability to evade detection. However, according to Professor Stotland (1999) white collar crime is not motivated solely by financial gain. He reports that motives and reasons for committing white collar crime are more connected with desire for money, threat of loss, sense of superiority, ego and power. In other words, greed alone is not the motivating factor to commit a crime. If applied to money laundering Stotland is proposing that greed alone does not drive the launderer – it is also a threat of loss, achieving a sense of superiority and feeding the ego that will drive the laundering. This means that a criminal (the launderer) has no respect for the authorities or rules since such respect will inevitably impede achieving a sense of superiority and power, confirming Levi and Pithouse's view.

The rules in place which outlaw money laundering and more specifically the money laundering officer within an organisation can be seen as the exposure to an alternative or conflicting behaviour under Sutherland's theory. However, money laundering is still a major global concern even with such rules and officers in place. Thus, it seems that a launderer will still be motivated to launder the proceeds of crime but will do so in an evasive manner that appears professional and legitimate – this is where it seems Stotland's theory is triggered – launder money in an evasive and clever manner to show disrespect for the rules and authorities and achieve a sense of superiority and power. For example, the professionals involved in the Enron scam all knew what they were doing – *mens rea* was shown to exist (Powers, 2002). They all knew that an alternative and conflicting behaviour existed but were motivated to ignore this behaviour. It would be improper and unsafe to say that the Enron professionals had criminal associations similar to what Sutherland theorised but it is proper and safe to say that part of what Sutherland theorised holds some truth when examining the Enron scam – an alternative and conflicting behaviour was visible but ignored (perhaps to achieve a sense of superiority and power.)

Sutherland also mentioned what he described as the "intelligent community" and how these individuals can be influenced by work peers to the extent that criminal behaviour is not criminal but an acceptable option. Although Sutherland does not mention what level of professionals he refers to as the vulnerable, the author believes that Sutherland refers to those who view their peers as their equals. The reason for this belief is that such employees are driven by hunger to succeed, and as Sutherland proposes, can be influenced to view criminality as an acceptable option. This is supported by Stotland's theory that criminals commit white collar crime to achieve a sense of superiority – those who are junior and take instructions do not have the desire to achieve superiority because they accept the hierarchy in the workplace. However, those who view their peers as equals do have the desire to gain the edge and become superior (Stotland, 1999).

Further, the "integrationist" theory adds some fuel to the debate in that the culture of competition is 'characterised by an intense desire for wealth and success and an overwhelming fear of failure;. Corporations within a capitalistic culture encourage the 'values, attitudes, and personality structures conducive to white collar crime' and thus, 'ensure an ample supply of potential violators'. In some instances, 'occupational positions virtually force their occupants to violate the law in order to succeed' (Coleman, 1989: 203-4). Thus, individuals are recruited with hard-driving personalities that value success are likely to seek out competitive corporate environments, enjoy career advancement, and possess a greater risk for involvement in criminal activities in the conduct of their work duties.

Applying this to an originator planning to launder proceeds of crime using securitisation, it seems that its employees would be classed as the vulnerable who are influenced to rule any suspicious activity as acceptable. Weisburd (1985) provides that ‘white collar criminals do not view their actions as criminal and themselves as criminals and that the reasons for committing the crime were to further the interests of the company’ (cited in Nelken, 1996).

This view can be attributed to the “rationalisation” theory which proposes that “neutralisation” occurs prior to the commission of the crime in question and serves as part of the motivation for the crime. Rationalisation theory helps to understand, from a psychological perspective, the individual and situational causes of crime, as neutralisation allows for the commission of an offence in the face of and regardless of contradictory normative expectations. Criminological research, for example, Coleman (1989) has revealed several neutralisations, including the belief that the action was not criminal because it did not hurt/damage the victim; represented borrowing with the intent to return/repay the debt; was necessary for survival within a competitive economy; was common practice; the employee was entitled to such fringe benefits or compensatory income.

This theory it seems would apply to the criminal behaviour of the originator who uses securitisation to launder proceeds of crime. Regardless of the rules in place and the various deterrents, the criminal originator is still motivated to launder the proceeds of crime because it “neutralises” the guilt and awareness of its actions before committing the crime by believing that it is not committing an offence. It seems the neutralisation occurs because it believes that the risk it is taking while laundering justifies keeping the proceeds of crime when they are cleaned. To fully comprehend the neutralisation process requires extending this discussion to psychological theories and understanding more about why and how the guilt and awareness of criminality can be suppressed. This extension is beyond the scope of this chapter. However, suffice it is to say that the rationalisation theory would apply to the criminal originator.

However, laundering is a crime that is hidden behind a fog created by falsity and those who assist to generate this fog may not be aware the criminal nature of their assistance. It seems Weisburd’s theory is limited to the employee knowing that it is doing wrong and consequently denying the criminality of the action. Where the employee is in the dark, influence may be applied upon these individuals so that their enquiries into what they are expected to do are minimised – in other words, they do not ask questions if they suspect anything.

A good example of this is Robin Greenburg of Western Woman's Group Pty Ltd who used her high status position as a qualified company director to defraud her clients of million of dollars. This was achieved by hiring employees that could not challenge her authority even though some of the employees were innocent accessories (Brown, 2001). In later research this was interestingly reintroduced and described as "sychophant association" and that such employees become organised conformists who are easily dominated (Duffield and Grabowsky, 2001). The extent of whether this is true can be gauged from recruitment policies of organisations particularly where behavioural analysis is undertaken as part of the interview.

Big organisations place a lot of emphasis on recruiting the right person who can fit into the organisation as opposed to recruiting the right person who can do the job (Luhmann, 1979). For this reason behavioural analysis has become a major part of the interview process where employees are asked questions about how they would respond to given situations and from their answers recruitment managers can assess their suitability and the extent of them conforming to the organisation's values and procedures (Beare, 1996). Beare believes that behavioural analysis tests are designed and used by organisations to look beyond the resume and into the mind of the applicant. His discussion, in short, also alleges that such testing allows the criminals within the organisation to use test results when conspiring to commit white collar crime. The author's view is that behavioural analysis can be used to find employees who can be easily conformed thus, achieving what Duffield and Grabowsky theorise.

Whether this influence and such theory go beyond the originator's employees is an interesting question which can be answered affirmatively. Each organisation recruits individuals who fit into the corporate structure and can conform easily to its values and culture. Again, behaviour analysis assists in recruiting the right individuals. Although occupational psychology is outside the scope of this discussion, the theory of behavioural analysis can be borrowed to demonstrate how organisations recruit and more importantly the reason behind the recruitment.

Professors Duffield and Grabowsky's theory is an excellent contribution and elaboration of the reasons behind recruiting particular individuals. They say that a corporate is likely to recruit an individual who can be moulded into the employee the employers wants. New entrants, particularly graduates, are susceptible to the training which primarily conforms the individual into the ideal employee. And further such an individual balances its needs for employment with the level of conformity it endures and will often conform easily. Thus, Professors Duffield and Grabowsky's theory, in the author's view, can be extended to cover all professionals who are recruited by organisations involved in a typical securitisation deal.

In conclusion, Sutherland has made a valuable point which applies to those engaged in a securitisation transaction – that professionals are given an alternative option which may prevent criminality. Additionally, that an employee can be influenced to view criminality as an acceptable option in certain circumstances where the employee may lose the possibility of achieving success.

5. WHY WOULD OTHER PROFESSIONALS ABUSE SECURITISATION?

What motivates individuals to conform and become white collar criminals? Each of the professionals instructed to facilitate the securitisation are governed by their own motives, organisational and occupational characteristics and culture. For example, the banker will be driven by its own motives, organisational and occupational characteristics and culture which would differ from that of the lawyers involved. The hunger to succeed within the banker's organisation differs from that of a lawyer within a law firm instructed to handle the legalities of the securitisation.

Though the element of hunger is inherent in each organisation, the manner in which it is exposed and the paths to realising goals differ considerably. A junior lawyer is aiming for partnership and seeks to impress the seniors whereas in a bank the junior member of the securitisation team is driven by bonuses – the junior is aware that a senior position is only available once a vacancy is created thus, concentrates on increasing his/her bonus. The juniors thus, have different motives and goals which will reflect in the influence they open themselves up to.

In contrast, this needs to be balanced with the nature of their respective duties within the securitisation transaction. If the professional is not aware of the criminality of his/her actions, is it proper to apply Sutherland's theory that unless it is exposed to an alternative or conflicting behaviour such professional will conform to what the employer expects and commit a white collar crime? It seems the answer is no – the employee is not given the opportunity to accept or view his/her actions as acceptable if the employee does not know that such actions are criminal. Sutherland's theory it seems works when the employee has some suspicion or is aware that the actions which the employer is expecting involves criminality, but due to external influences (work peers) conforms to the extent that it becomes acceptable to undertake such actions.

Does Professor Stotland's theory (white collar crime is not motivated solely by financial gain but more connected with desire for money, threat of loss, sense of superiority, ego and power) apply to professionals other than the originator? It seems that Stotland's theory works according to the hierarchy within the organisation. Junior personnel are not striving to demonstrate ego or superiority. They are focused on producing results which will promote them up the career ladder. However, those who view their peers as equals do have the desire to gain the edge and become superior. In the author's view these would be team leaders or senior management who strive to produce a comparatively bigger result for the organisation than junior members.

The "strain" theory provides an interesting reason for white collar crime. The theory proposes that a competitive marketplace creates a kind of strain which contributes to the reason why individuals engage in questionable behaviour in the pursuit of profits, market share, acquisition of desired information, and/or individual advancement (Poveda, 1994). Though Poveda discusses at length about how competition drives corporations to cut corners (reference is made to a study involving major car manufacturers in the US who pressurised their car dealers to operate even if they had to cut corners in order to survive economically), he does however, fail to mention what the author believes is a significant point that pro-competitive policies of nations in fact cause corporation to become competitive which then, in turn, sparks off what Poveda proposes – competition triggers the strain to survive. Pro-competition policies have introduced competition or anti-trust legislation in *most* common law jurisdictions with developed economies that can support and drive competition. Thus, any strain in the market which may ultimately lead corporations to cut corners must be attributed to these policies before sinking into the theory that Poveda proposes – a point Poveda fails to mention.

However, does the strain theory apply to professionals engaged in a securitisation transaction? It seems the answer would depend very much on the organisation's behaviour and culture. Each professional organisation instructed to handle key duties is governed by its own industry's competition forces which would influence the level of competitiveness the organisation undertakes in order to survive. Additionally, competition is also driven in part by economic conditions – slow conditions would cause the organisation to streamline its operations and operate more efficiently.

Balanced with this competitive force is the duty to operate in accordance with the law and the rules of professional ethics. Thus, it seems that in order to answer the question whether professionals in a securitisation transaction would be affected by the strain theory, one must look at the balance between competition forces and legal and professional duties – balance competition forces with legal and professional duties. Poveda fails to mention this point and focuses his discussion on the competition forces and the extent to which professionals would be influenced to undertake questionable behaviour.

The banker, the lawyers and the accountants involved are market leading organisations which experience competition forces daily. Their organisational structure and operations are carefully monitored internally so that their market share and turnover does not take an unexpected drop. Thus, organisations it seems promote their level of professionalism and expertise alongside maintaining their key clientele. But how far would they go? One commentator says that 'corporations are criminogenic because if legal means are blocked they will resort to illegal means so as to maintain or increase profitability' (Box, 1984: 258). This can be true if it is the originator who is planning to use securitisation to launder proceeds of crime. But to extend this beyond the criminal originator and say, in the absence of empirical research, other professionals involved would behave similarly would be unsafe and a mere generalisation. It is however, believed that professionals working for powerful corporations learn to justify questionable behaviour on the basis that *business is business* (Pearce, 1976). Moreover, Professor Punch believes that 'organisations may create climates where collective deviance is an acceptable answer to perceived institutional dilemmas, and where organisational culture, resources and facilities are intrinsic to the development of the deviance' (Punch, lecture: 17-19th April, 1991, cited in Nelken, 1996).

It is interesting that he uses the word "collective" to say that any intention to and actually undertake white collar crime is a group effort which they justify to themselves easily because each individual involved is supported by his/her work peers which, it seems softens the guilt – and perhaps softens the guilt to the point that Weisburd concludes – 'white collar criminals do not view their actions as criminal and themselves as criminals and that the reasons for committing the crime were to further the interests of the company'.

But would such professionals risk so much just to achieve profit? The answer, author believes, starts by saying that professional organisations would only in great exceptional circumstances risk their reputation and undertake questionable behaviour just to profit. Further, as some research shows some big organisations with so much to lose will ensure that they abide by the law. This research, although not directly relevant to securitisation and perhaps dated, nevertheless shows how corporations will, in the face of competition, still act with the law and the rules of professional ethics – US pharmaceutical companies who act according to what the Federal Drug Administration expects, ensure that they maintain the lucrative markets in which they are authorised to test and sell their drugs. Abiding by the law and rules of professional ethics ensure that corporations do not lose their credibility and reputation in an industry in which they wish to develop or maintain their dominance (Braithwaite, 1984). A damaged reputation can certainly impact upon profitability and lead to a loss of key clientele – Enron exposed the questionable and unprofessional activities of some Arthur Andersen executives which resulted in unreparable damage.

Additionally, the introduction of Suspicious Activity Reports (SARs) aims to ensure that professionals in vulnerable industries are compelled to report suspicious or questionable behaviour. A cynical response to this policy is that any report made is made to an internal officer who may not be independent from the questionable culture of the organisation. In the absence of any updated reported statistics it is difficult to say whether the policy behind SARs is in fact working. But the effect of this policy to compel employees to report certain activities needs to be balanced with a reluctance to report certain activities if such reporting will stifle the employee's success.

However, this point should be balanced with Professor Mars' view which concludes that 'perks, fiddles and neglecting regulations that can be seen as cumbersome and slowing down the pace of work may be undertaken to keep up with production schedules or to secure a fair day's pay' (Mars, 1982: 98). So it seems the duty to abide by rules is balanced with the duty to effectively produce results – and the author concludes that professionals may be forced to waver in favour of producing results and not place the same amount of emphasis on the rules.

A securitisation transaction is a specialism which is practised by market leaders in a given profession. The author believes that such professionals would balance the risk of losing their credibility and reputation with producing results for the employer. Any questionable behaviour would be done inconspicuously to such an extent that the professionals use their credibility, reputation and name to mask the questionable or suspicious element of their actions. Doing it this way, however, places the professionals in a dangerous position in that they have more to lose. Firstly, the very credibility, reputation and name they use to mask the white collar crime can be damaged irreparably – Arthur Anderson is a good example. Secondly, such use implies deception. Thus, where the professionals are operating in a niche market any damage can rock the boat of the whole industry – investors may lose faith in the securitisation market.

By operating in a niche market these professionals are still subjected to the market's forces of competition and this would trigger Stotland's theory – that motives and reasons for committing white collar crime are more connected with desire for money, threat of loss, sense of superiority, ego and power. But does this theory apply to an organisation operating in a niche market? The answer would depend on the whether one follows Stotland's school of thought. The author believes that in a niche market this theory would still apply even though the professionals and any potential offenders have more to lose in terms of market share. A niche market allows a small group of players to enjoy the fruits of that niche market, and maintaining credibility, reputation, trust and name is vital in order to remain a player. Thus, it would be highly damaging to risk one's credibility, reputation, trust and name particularly if operating in a niche market.

However, the vulnerability of securitisation which the author exposed in the preceding chapter is such that it has very little, if any, chance of detection. Proceeds of crime which are mingled with legitimate receivables cannot be detected unless a very detailed audit of the pool of receivables is conducted. But a detailed audit may not detect the proceeds of crime since paperwork can be manufactured or manipulated. Additionally, such proceeds of crime are more likely to materialise into cashflow than legitimate receivables because the launderer wants to get the proceeds into the financial system – thus, what loss can this cause to investors? Given that securitisation can be abused in this way and the chances of detection are low, it can be successfully believed that professionals operating in a niche market can be tempted to play along with the abuse. In other words, there is nothing stopping them from committing a white collar crime when their reasons are more connected with desire for money, threat of loss, sense of superiority, ego and power.

Returning to the question of whether professionals in a securitisation transaction would be affected by the strain theory, the answer it seems derives from balancing competition forces with duties to act lawfully and professionally. There are strong motives to act within the law and according to ethics in order to maintain credibility, reputation, trust and name within a given industry. There is also a proper system in place which allows individuals to report questionable activities to the authorities. However, against this is the desire of employees to succeed within their organisation, and reporting, although encouraged by employers, can also have a detrimental impact if the employers are engaged in questionable behaviour – grassing on the boss may be dangerous.

In contrast, the competition forces also dictate the level of questionable activity undertaken in an organisation. But it seems that since securitisation is a specialism practised by the market leaders, only these market leaders are running the race to secure profitability. In practice, these market leaders will have an established client base which would instruct them in the absence of any major fallout. Thus, external competition forces are still dictating the professional's behaviour. Internal competition forces also exist which can cause fellow employees to be competitive with each other. Thus, it seems the strain theory does apply to the securitisation market and may lead a professional to cut corners or contribute to questionable activities.

Does the "rationalisation" theory apply to other professionals? The short answer, and perhaps a generalisation, is that it does apply to other professionals. In order for a professional to engage in what it knows and believes is a criminal activity it must be confronted with an alternative path – the right path and the wrong path. The moment the professional chooses to commit the offence is the exact moment when the rationalisation theory is triggered and explains the suppression of the guilt and awareness of criminality. The professional neutralises the guilt and awareness of criminality by believing that what it is doing is not criminal – it seems it too believes that the reward it is to receive is justified by the risk it is taking.

An interesting point can be made in respect of whether the theory has full impact on the criminal acts of the lawyer involved. On the one hand the lawyer is fully aware of the rules in place and what the right path is. In contrast, any neutralisation that occurs can be the result of "lawyerly thinking" – cleverly manipulating the rules so that they read in accordance with the lawyer's actions. So does the theory apply to the lawyer? It seems where the lawyer can justify its criminality by believing that it is not committing a crime because the rules do not make it a crime – interpret the rules in accordance with the act – then the theory would not apply.

The theory, it seems, applies only when the person knows an alternative path but chooses not to follow it because he/she believes the crime is justified for some reason. The alternative path is the act of avoiding criminality. So an employee who thinks about dishonestly appropriating property belonging to his/her employer is faced with two options, either appropriate the property or choose not to do so. The alternative path here is choosing not to appropriate.

Likewise, a lawyer can report any suspicious activity to the authorities or choose not to do so. The alternative path is to act lawfully and report the suspicious activity. The lawyer, however, can interpret the alternative path as not being an alternative path. For example, a lawyer must report any suspicious activity to the authorities. Though the client/lawyer privilege is triggered, the lawyer must override this and report any money laundering activity which it believes its client is engaged in. However, the rules only require the lawyer to report what it suspects or knows which, in short, may be met by reasonable due diligence – the rules only require the lawyer to act reasonably. The test under the rules is however, subjective (do the authorities believe the lawyer acted reasonably?).

Thus, it seems that reasonable due diligence may hide the alternative path – after conducting due diligence the lawyer did not suspect anything therefore there was no need to report anything and consequently there was no alternative path. In contrast, where due diligence has not been exercised correctly then it seems an alternative path exists. So in conclusion it seems that this theory does not have the same impact on the lawyer as it does on other professionals – the accountants and bankers do have an alternative path just like any employee would have. The lawyer however, can manipulate the alternative path.

6. CONCLUSIONS

The author concludes his reasons why an originator and the professionals would use and abuse securitisation to launder proceeds of crime as follows:

1. Securitisation is a complex financing process which involves two complex transactions and several professionals. The complexity of securitisation and the credibility and reputation of the securitisation market both help to mask an important vulnerability which an originator can potentially abuse. The originator is more likely to abuse a process which it believes will facilitate its laundering process. There is a very low risk of detection, if any. The professionals involved are known widely and hold undoubtful credibility. To undertake a detailed audit of the pool is not possible given the timetable of a typical securitisation. False receivables can be manufactured. Proceeds of crime mingled with legitimate receivables are more likely to materialise into cashflow. If investors lose out then blame lies with the underlying obligors and the professionals who composed the securitisation. Thus, which criminal would not want to abuse a process that has such vulnerabilities?

2. In the context of securitisation and more specifically, money laundering, Professor Sutherland's theory is nothing more than a good introduction to white collar crime. Sutherland theorised that criminality is learnt through association with criminals and this association will dictate the development of criminal characteristics. Sutherland believed that unless an alternative and conflicting behaviour was introduced to the individual, the individual is more likely to develop criminal characteristics which would ultimately lead to participation in white collar crime. The

author accepts this theory to the extent that criminality is more likely to be learnt through association but disapproves Sutherland's point that an alternative and conflicting behaviour can prevent criminality. Money laundering is a crime that has grown regardless of what rules have been introduced. Launderers cleverly work around the rules. Thus, if such rules are seen as the alternative and conflicting behaviour then it seems that the growing concern relating to, and the reported facts about money laundering refutes Sutherland's point.

3. Professor Stotland introduced what, the author believes, is a good explanation for why white collar crime may be undertaken. Stotland theorised that the criminal commits the crime because there is a desire for money and superiority, and a threat of loss. This helps to explain why a launderer participates in the laundering process. The launderer wants to keep the proceeds of crime that have been generated through illegal activity – this is the desire for money and the threat of loss. The justification for keeping the proceeds of crime is the high risk the launderer is taking when generating and cleaning such proceeds. Stotland also adds that the criminal undertakes the white collar crime in order to achieve a sense of superiority – this, it seems, again refutes Sutherland's point on the alternative and conflicting behaviour preventing criminality. The launderer would still launder the proceeds even though there are rules in place, and in part would do so to achieve a sense of superiority – he has cleverly worked around the rules and evaded detection.

4. It is important to also understand how white collar crime seems to develop within an organisation given that there are rules in place which aim to prevent such behaviour. There are theories that attribute to the development of white collar crime within an organisation. The author believes that organisations which desire to commit white collar crime will do so in an environment which it has developed itself – organisations will recruit individuals who can be easily moulded to work in its culture and environment. This was researched by Professors Duffield and Grabowsky who conclude that that a corporate is likely to recruit an individual who can be moulded into the employee the employers wants. The author also highlighted the case of Robin Greenburg. Once conforming individuals are recruited they are then exposed to the culture of competition which is characterised by an intense desire for wealth and success and an overwhelming fear of failure to the extent that occupational positions virtually force their occupants to violate the law in order to succeed. Weisburd goes further to say that where criminality becomes part

of the workload then 'white collar criminals do not view their actions as criminal and themselves as criminals and that the reasons for committing the crime were to further the interests of the company'. But Weisburd's theory is limited to the employee knowing that it is doing wrong and consequently denying the criminality of the action. This research, however, also demonstrates the extent to which employees would push themselves within the culture of competition which would trigger the "rationalisation" theory. This theory it seems would apply to the criminal behaviour of the originator who uses securitisation to launder proceeds of crime. Regardless of the rules in place and the various deterrents, the criminal originator is still motivated to launder the proceeds of crime because it "neutralises" the guilt and awareness of its actions before committing the crime by believing that it is not committing an offence. Thus, the structure and culture are important contributing characteristics which dictate the level, if any, of white collar crime committed by the organisation and its employees.

7. WHO IS LIKELY TO ENGAGE IN WHITE COLLAR CRIME?

White collar crime theories have also been developed and extended to answer the question: who is likely to engage in white collar crime? Although, it important to have an understanding of what motivates criminality and how this understanding relates to securitisation, the author believes it is equally important to have an understanding of the type of individual who is likely to drift into criminality when involved in a securitisation transaction. The crime which anyone involved in a securitisation is capable of committing is that of money laundering.

A good starting point for the discussion is to look at the types of organisations which actually involve themselves in this complex transaction. Earlier parts of this work mentioned that bankers, trading corporations, accountants, lawyers, and credit rating agencies are actively involved in a typical securitisation transaction. It would be unsafe and perhaps defamatory to generalise that these individuals would certainly abuse securitisation to launder proceeds of crime. However, history has given examples which inspires thought and causes a closer look at these individuals and their duties.

For example, the failure of the Bank of Credit and Commerce International (BCCI) exposed a number of key points and vulnerabilities - BCCI's criminality included fraud and money laundering operations in Europe, Africa, Asia and the Americas. Among BCCI's mechanisms for committing crimes were its use of shell corporations and bank confidentiality and secrecy havens; layering of corporate structures; its use of front-men and nominees, guarantees and buy-back arrangements; back-to-back financial documentation among BCCI controlled companies; and bribes. This highly publicised criminal operation teaches us that bankers are capable of laundering money in the face of rules and regulations. It teaches us that professionalism is not always a squeaky clean image. It teaches us that those involved in criminality are determined to achieve what they set out to achieve. Additionally, Enron exposed more vulnerabilities of the financial system and reinforced the belief that criminals too can dress up in nice suits and hold a respectable office.

So what type of person becomes vulnerable to drifting into criminality? The discussion on the motives can be integrated into or linked with a discussion on the type of person likely to become a white collar criminal. In other words, what type of person is more likely to be motivated to drift into criminality? The author believes that if motives can be understood then this can indicate the type of person who will stoop to criminality. But what should be considered first - their motives or their personality in order to ascertain the type of person more likely to assist in laundering proceeds of crime? For example, what type of personality is likely to fall prey to internal competition and resort to criminality in order to succeed? Aside from personality other factors should be brought into the debate – gender and situational influences. This broadens the debate so that a better understanding of issue can be achieved.

1. Personality

Researchers have studied the ways in which certain personality characteristics interact with "situational variables" and result in occupational crime. It is believed that 'personality characteristics shape behaviour by moderating decision-making in the face of unique contextual influences' (Terpstra et al., 127(4): 375-389). Moreover, the following variables lead to involvement in criminality: interpersonal competitiveness, narcissism, impulsivity, external locus of control, high need for achievement/praise, low self-esteem, and low levels of religious conviction.

In their study of insider trading and ethical decision-making Terpstra et al., concluded that individuals with high levels of competitiveness and "external locus of control" were more likely to engage in unethical decision-making. They suggest that 'the competitive drive to win at all costs impacts upon ethical decision-making'. In other words, it seems that they are theorising that those who have a strong desire to succeed are more likely to "bend the rules" and unethically play their part in a transaction. It is unclear what is meant by "external locus of control" although they mention 'the outer circle' which the author believes includes those who are outside of the “inner circle” but strive to gain access into it – a junior attempting to gain access into management circle. The Hogans' study (1997) of mid-level managers attempted to identify the personality characteristics associated with workplace betrayal. They advanced the ‘theory of the hollow core’ which characterises betrayers as ‘outwardly self-confident and charming and inwardly self-doubting and rash’. They theorise that ‘betrayers hide their competitive and self-promoting nature behind a charming and persuasive veneer and selfishly view others as tools for satisfying their personal and material need’. Although a good theory and supported with empirical research, the theory itself is limited to those who commit against the employer – ‘betrayal in the workplace is betrayal against the employer’.

There is very little research which links personality characteristics and financial crime. The abovementioned research focused on insider dealing and crimes against the employer. Money laundering is also a financial crime of major concern, however, the author believes that attempts to understand the personality characteristics of money launderers has to be pieced together from existing research on insider dealing. There is, of course, the danger that any findings may amount to nothing more than interpretations of existing findings – understanding the personality of an insider trader and transmuting it to the money launderer. However, both insider dealing and money laundering are crimes that manipulate others and the financial system. Thus, to a certain extent there are commonalities between the two which can be used as a basis for understanding the personality of a money launderer.

The starting point is that, ‘money laundering is not conceived by wicked individuals in some Dickensian ‘den of crimes’. Rather it is planned, executed and concealed in clean, respectable, warn and well lit city centre offices, by quiet men/women in smart clothes who do not raise their voices and keep a relatively low profile’ (Sikka, 1996). So is it a personality characteristic that is added to the individual which leads him/her to launder money?

The research of Terpstra et al is perhaps the most authoritative discussion, to date, on white collar crime and personality. They say that having a personality which makes an individual conform in the face of competitive forces is a personality characteristic which can lead to criminality. Coleman opines that, ‘white-collar crime is perhaps best theorised as an activity that is increasingly undertaken by organized groups, corporations and elite occupations which operate within the values of capitalism and provide competition and conflict. ‘Bending the rules’ is often regarded as a sign of business acumen’ (1989: 85). The Hogans’ study also strongly mentions competition as a causative factor which leads to criminality. Thus, it would seem that those who are competing against others (whether internally or externally) can be isolated into the category from which white collar criminals will develop. But this category contains just about anyone and everyone with employment. Thus, there must be a particular factor or ingredient which is causative of white collar crime.

It is widely known that money laundering is undertaken by those who are connected with the financial system or have knowledge about how it works. Thus, this reduces the size of our category from which money laundering white collar criminals will develop. Weisburd concludes that, ‘white collar criminals do not view their actions as criminal and themselves as criminals and that the reasons for committing the crime were to further the interests of the company’ (cited in Nelken, 1996). Add to this Stotland’s theory that white collar crime is not motivated solely by financial gain but also includes reasons more connected with desire for money, threat of loss, sense of superiority, ego and power. And, from this it can be deduced that those who wish to (1) further the interests of their employer and (2) who have a strong desire to profit and (3) gain a sense of superiority, are now the remnants of the category from which white collar criminals can develop.

The author accepts that such a description is still vague to single out conclusively the type of person or personality which leads to criminality. However, the author does believe that such a description is a good starting point to ascertain links, if any, between personality and criminality. Moreover, the author also believes it is difficult, if not impossible, to provide a clear criterion of personality characteristics which can be attributed to criminality. The reasons for this belief is that firstly, there is no evidence, to date, which suggests that money launderers have abnormal psychological characteristics or other mental difficulties, and secondly, Mr Abedi of BCCI and the professionals involved in the Enron scandal, for example, were intelligent businessmen who had a strong desire for money and power and wanted to gain a sense of superiority that they have “beaten the system”. This characteristic is not abnormal since greed lives in all of us. Perhaps the answer would lie in analysing links between criminality and non white collar offences. However, this throws up another debate as to whether white collar crime should be viewed as “normal” crimes committed outside of the office. If one takes the view that there is no disparity between these two categories of offences then it may be possible to study the personality characteristics of non-white collar criminals and transmute the characteristics over to white collar criminals. But the interesting point is that the category and definition of white collar crime was invented primarily to disassociate crimes of the respectable office holders from other offenders known as “street criminals” (Mars, 1982).

There is research which comparatively analyses white collar offenders and street offenders to identify areas of overlap and divergence. Wheeler et al believe, in short, that, *occupational* criminals and ordinary offenders share similar deviant characteristics’ and that, ‘white collar offenders have higher levels of educational attainment than both common criminals and the general public and higher rates of employment than non-violent common criminals’ (Wheeler et al, 1988: 331-357). Gottfredson and Hirschi say that occupational criminals do not differ from common criminals since ‘both engage in criminal acts because of deficits in self-control, a desire for self gratification, certainty about outcome, and an opportunity to commit offences’ (1990). However, they presented no new data to support their views and instead loosely reviewed existing research that supported their paradigm.

Wheeler et al focuses on motivations for offending and concludes with four categories of motivations: greed, fear of failing, ideology, and revenge seeking. He says that ‘greedy offenders are risk seeking and motivated by getting more of what they already have. These offenders relentlessly pursue personal advancement, with each increase in income or assets creating a greater willingness to engage in unethical and/or illegal behaviour’. Those offenders motivated by the fear of failing or losing what they already have worked so hard to achieve evaluate ‘all gains or losses against their current position. This evaluation process tends to magnify losses and minimize gains, thus perpetuating the fearful stance of the offender. For these individuals, the utility of the illegal act is determined by the net balance of gains and losses, and not by their final asset position’. Whereas, ‘ideologically driven offenders’ engage in white collar crime ‘to make a statement about their beliefs and values’. This motivation or personality is often seen in tax protesters and embezzlers who see their behaviour as a ‘resistance against and/or moral condemnation of powerful organizations’. Finally, revenge seekers use their ‘unhappiness and anger to justify their criminal actions against corporate or governmental entities’.

Benson and Moore (1992: 251-272) conclude that white collar criminals have ‘at least moderate, if not considerable self-control’ and that ‘their involvement in crime occurs only when this self-control is overridden or redirected’. They further propose that some complex interaction of motive (greed, fear of failure) and opportunity causes individuals to act criminally. Although, there are numerous studies which in their own way authoritatively link personality and criminality, the studies do lack association with money laundering. As said earlier, there is little research, if any, which links personality and money laundering so that a better understanding of characteristics can be achieved. The author concludes that existing research does direct an answer – that a money laundering white collar criminal will have characteristics which cause (1) a strong desire to profit and succeed, and (2) the motivation to take a risk, and (3) the ability to recognise a risky yet profitable opportunity, and (4) the ability to cleverly conceal the illegality of an action. Though this conclusion is arguably vague and perhaps transmuted from personality characteristics of non-white collar offenders, it is, however, a good starting point in understanding the type of person likely to use securitisation to launder proceeds of crime.

2. Gender

The myth that women are less likely to engage in criminality than men has also been examined in order to ascertain any differences. Zietz (1981) examined gender differences in the nature of and motivations for white collar crime. She found that 'women continue to be at significantly less risk for criminal involvement than men'. Her research centred on arrest data that suggested women constitute 35-43 percent of the arrests for embezzlement and fraud. In her judgement this figure surpassed female arrest rates for "street crimes" (aside from prostitution). Daly (1989) also studied gender differences and expanded on Zietz's work. Daly concluded that 'females' crimes resulted in smaller losses and were less complex, shorter in duration, and more likely to be carried out independently'. Furthermore, women were 'significantly under represented in antitrust or SEC violations, the two most common corporate crime violations'. Given these findings, Coleman proposes that 'differences in opportunity and moral reasoning result in gender disparities in the motivations for and scope of white collar offending' (1989).

In the context of securitisation the author believes that Coleman's conclusion is accurate given that websites of the leading players in the securitisation industry all have a tendency of showing men occupying senior positions. Women are under represented in securitisation teams in law and accountancy firms, banks and credit rating agencies. So does this mean that women are less likely to abuse securitisation to launder money?

It seems that that the answer is affirmative for two reasons, firstly, the abovementioned research, though limited, however, shows the trends in gender differences, and secondly, except in exceptional situations, women unfortunately are still the victims of working in a building with a "glass ceiling" – they are not given equal opportunities of promotion to senior positions. Though this is arguably a generalisation, the author, however, does take the view that women are less likely to abuse securitisation to launder proceeds of crime.

3. Situational influences

The author has discussed personality characteristics and gender as possible signs that identify a class of people who are likely to abuse securitisation. As a follow on it is worth looking at situational influences which may affect those who engage in securitisation. "*Being in the right place at the right time*" denotes the seizure of an observed opportunity. This seizing of an opportunity is also an important consideration when determining who is capable of abusing securitisation.

In order to work out which persons in which occupations are at risk of abusing securitisation, the discussion needs to be based on the motives for abusing securitisation. An understanding of the motives can help to ascertain which persons would abuse their professional position. Those engaged actively in a typical transaction are the banker, lawyer, accountant, and the rating analyst. The previous chapter analysed their duties and whether each of these professionals were capable of abusing securitisation to launder money. The banker is the producer and director of a typical securitisation. It has the know-how and the contacts. The preceding chapter discussed and concluded that the banker is in a position to abuse securitisation – it can assist a criminal originator to launder proceeds of crime by cleverly structuring the transaction to evade detection.

The accountant is also in a position where it can assist in concealing certain financial information to facilitate the laundering process. The lawyer and the rating analyst can only assist in the laundering process if they have knowledge about the laundering activity. They are not in a position to detect whether receivables are proceeds of crime. They can, however, assist in structuring the transaction so that it can evade detection. These professionals are highly intelligent individuals who enjoy high levels of respect, credibility, trust and authority. And, they can use and abuse their professional position to facilitate money laundering.

But which of these professionals have the characteristic that will lead to criminality? As stated earlier, Stotland introduced a good explanation for why white collar crime may be undertaken. Stotland theorised that the criminal commits the crime because there is a desire for money and superiority, and a threat of loss. This, as said earlier, helps to explain why a launderer participates in the laundering process. The launderer will want to keep the proceeds of crime that have been generated through illegal activity – this is the desire for money and the threat of loss. The justification for keeping the proceeds of crime is the high risk the launderer takes when generating and cleaning such proceeds of crime.

Stotland also adds that the criminal undertakes the white collar crime in order to achieve a sense of superiority – the launderer would still launder the proceeds even though there are rules in place, and in part would do so to achieve a sense of superiority – he has cleverly worked around the rules and evaded detection. This theory helps in that only those who are not highly regarded in the industry but have a strong desire to gain recognition will be tempted to participate in a transaction which would cleverly conceal money laundering – the professional wants to be part of the sophisticated plan. The fact they are not recognised in the industry may justify their motivation – they feel a threat of loss if they do not gain recognition in this niche market. In the author views, such a professional would demonstrate characteristics which reflect greed, craftiness, the desire to achieve a reputation at all costs, and the ability to find solutions without considering their legality or morality. Those who have these characteristics are more likely to manipulate junior employees – an organisation recruits individuals who will fit into its culture and environment, and who will conform easily. These juniors, as said earlier, face internal and external competition which will influence their work behaviour. The junior employee may not know that it is participating in criminality, and the seniors would be careful to keep the criminality concealed for fear of any potential whistle blowing by a junior.

Again, the author admits that these conclusions are arguably vague simply because it is difficult to accurately compose a list of individuals who would engage in abusing securitisation. Further, every professional is uniquely designed and money laundering is a sophisticated crime which does not require conspicuous traits. The author has, however, attempted to provide a conclusion, based on existing research which is a good starting point for ascertaining who is capable of using and abusing securitisation to launder proceeds of crime.

CHAPTER 8 CONCLUSIONS

The introduction and continuous evolution of securitisation has certainly made a significant contribution to the world of corporate finance. Since its inception a number of commentators have contributed to the field of securitisation. There were nevertheless issues which required an in depth examination so that knowledge surrounding these issues became clear and comprehensible. The author has attempted to clarify and expand some of these issues – some in a subtle way and some as a clear contribution to knowledge. This part of the work puts forward the findings:

1. The correct nature of securitisation
2. How securitisation has evolved
3. The legal problems associated with the transfer of the receivables
4. The problems associated with the SPV
5. Securitisation can facilitate money laundering
6. Securitisation and its relationship with white collar crime

1. The correct nature of securitisation

Many commentators have provided definitions for securitisation. Some of these reflect securitisation while some seem to be based upon reiterations of a misplaced focus. In chapter one the author examined several definitions which, in the author's view, inadequately reflected securitisation. They each had their own inaccuracies which, the author critically examined for two reasons. Firstly, to add an element of critical analysis into the discussion, and secondly, to clarify the correct nature of securitisation.

The author's definition of securitisation is 'utilising the historical and predicted performance, the collateral, creditworthiness and cashflow of an entity's assets as security to raise finance from the capital markets'. A misunderstanding relating to securitisation is that it is the originator that undertakes the actual securitisation. This was examined using the author's definition to conclude that the party that actually undertakes the securitisation is the party which '[utilises] the historical and predicted performance, the collateral, creditworthiness and cashflow of…[its]…assets as security to raise finance from the capital markets'.

Where the transfer is drafted as "true sale" then the SPV becomes the legal and beneficial owner of the receivables. And as owner it has the right to grant a security interest in the receivables in exchange for funds. Thus, as the legal owner it has the right to use 'the historical and predicted performance, the collateral, creditworthiness and cashflow of…[its]…assets as security to raise finance from the capital markets'. However, where the transfer agreement is not drafted to reflect "true sale" or is recharacterised as secured lending, the party undertaking the securitisation is the originator since it remains the legal and beneficial owner of the receivables. It has the right to use 'the historical and predicted performance, the collateral, creditworthiness and cashflow of…[its]…assets as security to raise finance from the capital markets'. The originator either sells the receivables under what is known as "true sale" or pledges them under a "non-true sale" transaction. What is the difference?

The originator will use securitisation to achieve one of two objectives – either to remove risk-embedded intangible assets off its balance sheet or raise favourable rated finance from the capital markets (which may be restricted due to its credit rating or balance sheet). In the former, the originator will aim to sell the receivables under a "true sale" agreement so that the receivables no longer appear on its balance sheet – the receivables are legally sold in a manner that satisfy the accounting requirements. In the latter, the originator may just be seeking favourable rated finance so it pledges the receivables to the SPV which uses the receivables as the source of repayment for the borrowed funds. The majority of securitisations that take place are structured to achieve "true sale" so that the funds borrowed from the capital markets do not appear on the originator's balance sheet – hence off-balance sheet finance.

2. How securitisation has evolved

The two key reasons why securitisation has experienced phenomenal growth are that it allows an entity either to raise finance which is favourably rated or to remove risk-embedded assets off its balance sheet. A common reason for using securitisation in both scenarios is competition. Financial institutions strive to profit by offering a range of financial products which require a good balance sheet. For example, discounted loans and pensions funds require the financial institution to have sufficient capital and financial reserves. Thus, securitisation allows the financial institution to remove risk-embedded assets off its balance sheet and free up capital to cover another type of risk. It also provides finance instantly which can be invested in new projects. Globalisation (and the surge in cross border activities) has increased competition among financial institutions, and consequently has created opportunities for financial engineering. Securitisation allows the financial institution to increase its lending capacity without having to find additional deposits or capital infusion. The financial institution becomes more visible to the outside world and investors through the process of securitisation.

A non-financial entity also strives for profit and seeks new opportunities to prosper. Securitisation allows this entity to remove any risk-embedded assets off its balance sheet and gain access to instant funds. Further, the entity can gain access to favourable rated finance which is not limited by its corporate rating. Moreover, any dips in the economy may cause an entity to re-think and restructure its operations so that any loss can be compensated for by gaining from other opportunities. Securitisation allows an entity to gain funds to invest in new projects.

Another strong reason for the growth of securitisation is the increasing shift towards seeking alternative financing sources as opposed to the traditional commercial loans from financial institutions. Downgradings in corporate and/or sovereign ratings have led entities to seek alternative financing options. Raising finance through securitisation does not rely on an entity's business operations – the focus is on the strength and reliability of the receivables which act as support for the bonds. A bond issue created through securitisation is rated according to receivables as opposed to the entity generating the receivables.

3. The legal problems associated with the transfer

The most significant issues facing the originator are firstly, whether the transfer agreement accords with the parties' intentions, and secondly, that the transfer is not nullified on the grounds that it constitutes a sham.

A *true sale* transfer can be challenged as invalid by the courts regardless of what the lawyers, the credit rating agency and bankers opined when constructing the transaction. Although English law currently lacks any direct rulings regarding true sale transfers, the research examined the US rulings in order to gain some familiarity with how the US courts view true sale under securitisation. The US rulings show that a court will firstly, look beyond the wording used in the transfer contract by examining the actual business activities, objections and the relationship between the parties. Wording such as 'sale and purchase' do not satisfy the court that the contract depicts a sale. Instead words such as 'assigns, sets over and transfers all rights, title and interest' must be used since such wording defines and describes the parties' obligations in respect of true sale.

Secondly, the courts also look at the actions of the parties in order to determine whether the wording correlates with their actions. Where the wording differs significantly courts have been quick to strike down an intended transaction and deem it secured lending.

Thirdly, case law was examined in order to gauge judicial understanding of securitisation. The case of *Major* highlighted the court's view in respect of recourse provisions in the transfer agreement. The recourse provisions were viewed as excessive and contrary to properly transferring credit risk yet the court failed to indicate what an acceptable level of recourse would convince judges that a securitisation with recourse provisions is still a securitisation.

Thus, it seems that in the US, recourse provisions which are "excessive" are interpreted as not transferring all risks whereas, in England and Canada it has been held that 'full recourse is not incompatible with a concept of a legal sale'. But the US ruling did not indicate whether it would find recourse provisions that fell below 'full recourse' as excessive. It seems the recourse question needs a further examination by the US courts.

The decision in *Octagon Gas* shows how a court misinterpreted the U.C.C. Article 9 in finding that an assignment of accounts merely creates a security interest. Under this judicial interpretation of Article 9, a seller and SPV can never effectuate a true sale of receivables. Without the ability to transfer full title of ownership, securitisation will cease to exist because the transferred accounts will always be subjected to the potential bankruptcy of the originator as part of its estate.

The *Days Inn* case raised a number of significant yet disturbing points. Despite the presence of several factors mitigating against consolidation, the bankruptcy court ordered substantive consolidation of the assets of the issuer with the estate of DIA. The court failed to recognise that the SPV was a separate entity – it failed to recognise the presence of an independent director – it failed to recognise that the *Octagon Gas* case caused controversy by failing to appreciate what securitisation was. Nevertheless, the court recharacterised the transaction thereby voiding the asset transfer which, raises the question – do courts actually understand the mechanism behind securitisation?

A perfectly structured transfer for securitisation purposes would not lead to recharacterisation, and further it would not cause controversy if judges had a better understanding of securitisation. It seems that the courts have taken the process of securitisation and tried to fit it into established principles of law when in fact the law should be shaped around the process of securitisation. Securitisation is a series of distinct transactions which are clearly recognisable if the law is shaped around the transactions. But to attempt to fit this process into principles of law distorts and detracts from what the parties intend. The author discussed possible solutions to this problem – the theories of Aicher and Fellerhoff, and Bjork – before concluding with a workable solution: analyse the whole structure; investigate the separateness of the originator and the SPV; investigate the SPV; ascertain the market value of the receivables; closely read the transfer contract; whose duty is it to ensure income passes to the SPV?; who bears the risk in excess of all credit enhancement?

4. The problems associated with the SPV

The author examined the legal issues facing the SPV: correct form and location; it acquires a bankruptcy remote status; independently controlled and operated; perfection of security interest in the purchased receivables.

i. The correct form and location of the SPV is crucial so that it corresponds with the law and content of the contract, the type of security the SPV will issue, the investor base the bonds are targeted at and the desire to minimise the imposition and amount of taxation. The correct form of the SPV determines what kind of securities it will issue. In the UK, for example, a SPV created specifically for securitisation takes its initial form as a private limited company – a special purpose vehicle. It lies dormant until the securities' offering has been arranged. Prior to launching the issue the private limited company is re-registered as a public limited company.

In the US, the SPV is either structured as a General corporation, 'S' corporation or Limited liability corporation (LLC) depending on the desired tax treatment and the type of payment structure. A General corporation is liable to pay tax on any earnings made whereas, the "S" corporation was designed as a tax-free entity with an important restriction – income can only pass through the entity in order to elect a tax-free status. The LLC was born from the advantages of its alternatives, for example, a General corporation is subjected to double taxation, once at corporate level and again at a personal level whereas, the LLC is only taxed once at a personal level – investors pay at their personal rate. Other advantages include, no citizenship requirement – the 'S' corporation restricts non-residents as shareholders thus, those who own the equity of the SPV must be US residents which can prevent foreigners from owning a SPV in the US. Further, the LLC has no limitations on the size and number of its members, no tax penalties upon its liquidation, no limitation on ownership of other corporations and allows limited liability to all members including those who participate in management. Thus, this became an ideal SPV for securitisation purposes.

A trust is also a useful SPV – in the UK, the trust established for purposes of securitising receivables takes the form of an express trust created via a trust deed. The US has created three types of trusts, grantor, owner and master trust. A grantor trust is structured specifically so as to enable it to acquire a non-taxable status. An owner trust will not qualify as a non-taxable trust because the trust manager is empowered to deal with the cashflows of the receivables. A master trust is used so as to give the issuer access to multiple markets simultaneously.

In a private offering, one which is accepted by sophisticated purchasers, participation certificates are offered giving investors interest in the receivables, rather than in the trust, as is the case in a public offering. The important distinction between private and public offerings is that in the former, the investor has a direct link with the receivables due to the interest he or she acquires in the receivables and can enforce rights without an intermediary whereas, in the latter, the investor normally has an indirect link with the receivables as he or she owns an interest in the trust only. This is because the link with the receivables is through an intermediary (normally a trustee) who is utilised by the issuer to handle the physical administration of the issue for reasons of convenience and cost effectiveness. In the event of a default the trustee will enforce rights on behalf of the investor.

ii. The "doctrine of substantive consolidation" means 'the merger of separate entities into one action so that the assets and liabilities of both parties may be aggregated in order to effect a more equitable distribution of property among creditors'. It is triggered if the originator is so closely related to the SPV that if the originator faces bankruptcy proceedings the SPV's assets can be used to pay the originator's debts. The rating agency will insist that the SPV is not owned or operated by an entity that is far from bankruptcy remote. The rating agency as well as the courts will analyse the relationship between the SPV and its parent or disguised parent by utilising an "*alter ego*" approach.

In the UK, the case of *Smith, Stone & Knight* deals with consolidation, although not in the context of securitisation but offers useful guidance. But English law in relation to consolidation goes back to the authoritative case of *Salomon v Salomon & Co Ltd*. The case established the principle that a company upon incorporation is a new and separate artificial entity – a distinct entity with its own personality separate from and independent of the persons who form it, who invest money in it, and who direct and manage its operations. Thus, the rights and duties of a company are not the rights and duties of its directors or members who can be hidden by a corporate veil surrounding the company.

However, the US has witnessed a different picture regarding consolidation. In the case of *Re Vecco* the court stated that a determination of whether to allow consolidation should be based on the following criteria: firstly, the degree of difficulty in segregating and ascertaining individual assets and liability of the companies. Secondly, the presence of consolidated financial statements. Thirdly, the 'profitability of consolidation at a single physical location'. Fourthly, the commingling of assets. Fifthly, the existence of parent and inter-corporate guarantees on loans and finally, the transfer of assets without formal observance of corporate formalities.

The concluding disparity in how the UK and US courts approach consolidation is notable – the UK courts are reluctant to order consolidation in the absence of a sham or fraud whereas, in the US, the courts will seek out links between the SPV and the originator and order consolidation. It seems that there is presumption of consolidation unless proven otherwise.

In order to avoid consolidation, the author discovered that parties must ensure the SPV maintains separate books and records pertaining to its operations; there is no commingling of assets, funds or accounts; the SPV holds itself out to the public as a separate and distinct entity; the SPV prepares its own tax returns (if relevant); an independent director is seated on the SPV's board; the SPV's assets are clearly shown on its financial statements; the SPV will not pay or guarantee the debts or obligations of its parent or affiliate and vice versa; any transaction between the SPV and the originator should be at arm's length and, the SPV utilises its own letterhead, telephone and operational offices.

iii. Aside from the SPV ensuring that the receivables are purchased correctly from the originator, it also needs to ensure that it itself is "bankruptcy remote" – which means that the SPV is not threatened with potential bankruptcy. The SPV can be made to hold a bankruptcy remote status but it can never be made bankruptcy proof. Many commentators concisely restated how such bankruptcy remote status is achieved, however, the author discussed bankruptcy remoteness at length and concludes:

a. The incorporation documents should list which party(ies) the SPV can transact business with. Where the SPV is created for a "one-off" securitisation then its ability to purchase additional pools of receivables should be restricted so that it does not expand its list of creditors (which in all cases should be kept to a minimum).
b. The documents should also include details of the activity the SPV is permitted to undertake. Since it is created for a special purpose with limited operational parameters, which are dictated by the rating agency's analysis, these should be included together with all restrictions so that the SPV cannot

transact business which it is not permitted to undertake.

c. Steps should be taken to minimise any threat of involuntary bankruptcy that can be posed by creditors – but the author examined US case law which shows how creditors can cause difficulties internally – SPV's bylaws are easily circumvented.

d. The inclusion of an independent director to operate the SPV alongside its existing directors. The author questioned the independence of such a director and concludes that as a director of the SPV he/she owes fiduciary duties to the shareholders which need to be balanced with his/her obligation to protect investors from leading the SPV into voluntary bankruptcy. Thus, in reality, he/she owes duties to both the shareholders and the investors – a conflict of interest. The shareholders may bring an action against the independent director for breach of fiduciary duty based on a refusal to sign a petition when it is in the best interest of the SPV. The investors too can bring claims against the originator and the SPV's directors for failing to protect investors if such provisions fail to protect.

5. Securitisation can facilitate money laundering

The author believes that the process of securitisation is open to abuse and can potentially be utilised to facilitate money laundering. Enron is an example of how the structure of securitisation was abused. The author put forward a theory that:

i. there are no rules prohibiting criminals or launderers from securitising legitimate rights to payments;
ii. the receivables sold or pledged can be proceeds of crime;
iii. there is no method for determining or verifying whether the receivables are proceeds of crime;
iv. the professionals involved cannot detect whether a pool contains proceeds of crime;
v. the receivables are placed into the financial system when they are transferred to the SPV.

Is this theory true? A step by step guide towards the answer:

i. The originator will approach a banker with the intention of raising finance either by removing receivables off its balance sheet or keeping the receivables and using them as security for finance. The process begins with an analysis of the originator's business operations. The originator will present itself as a business with a balance sheet of receivables. The receivables will appear as figures in the balance sheet – though supplementary information with the balance sheet will state the nature of the assets and explain the figures. Aside from this the balance sheet will not detail the receivables.

ii. The next step in the process is isolating the receivables into a pool so that the banker can calculate how to structure the securitisation. The isolation is discussed with the banker who will want to ensure that it is satisfied that firstly, the receivables exist, secondly, the originator is the legal and beneficial owner, thirdly, the originator is not breaching any prohibition clauses in other agreements by disposing the receivables, fourthly, the originator can transfer the receivables without causing loss to its operations, fifthly, the receivables have a legitimate source.

iii. The receivables are presented as computer printouts which list the account numbers representing the underlying contracts together with outstanding amounts owed by the obligors. The banker relies very much on the representations given by the originator and the supporting documents presented (though the banker warns that should the receivables not exist or they are removed in breach of any restrictions or such removal would economically damage the originator, then this would amount to fraud.) How much can the banker verify? Firstly, it is impractical to verify each receivable in a pool. Secondly, the legal title can be verified by assumptions – if the receivables exist on the balance sheet then look to who is the owner of the balance sheet.

iv. Can the banker verify the source? The banker will examine the originator's business operations to ascertain its productivity, prosperity, and legitimacy (based on the financial statements (including tax filings) and general knowledge within the originator's industry). However, it is possible for the originator to have business operations which do not appear in its financial statements. The banker will examine the originator's financial statements and any other documents given by its accountant and banker in order to work out the extent of the originator's business operations. The financial industry relies very much on trust and the integrity of the parties who utilise it. The receivables are intangible property which only exist as computer printouts and thus, can be falsely manufactured – so is it difficult for the banker to recognise the difference between proceeds of crime and legitimate earnings? The banker can only exercise due diligence and investigation to a certain extent before the investigation becomes impractical – 'it's a tough position to be in, particularly when dealing with a less known originator, but given the pressures we are under we have to go with what the originator will tell us'. Add to this the fact that every bond issue is structured according to a deadline which is often dictated by the capital markets. Thus, in most cases the banker may be working against the clock whilst ensuring that reasonable and practical investigations are undertaken. Add to this the fact that the contents of the pool are under constant change – the receivables are exposed to prepayment and default risk which can be controlled by allocating reserves but nevertheless motivates the banker to act speedily.

v. The next step in the process is analysing the pool from a credit rating perspective. The credit rating agency will closely analyse the receivables for any credit, structural and legal risks. Since dirty money mingled with clean money does not cause any detrimental financial effect upon, or reduces or impacts upon, the cashflow or value and collateral of the pool, the criteria under the testing scenarios does not consider the effects of dirty money mingled with clean money. The author contacted the leading rating agencies and posed the question – *Is it possible for a credit rating agency to recognise or detect proceeds of crime which may have been mingled with legitimate earnings in an isolated pool of receivables? If so, how?*

Moody's stated that 'many agencies would be reluctant to give a detailed answer'. The reason for this is 'because [I am] exposing vulnerabilities of an established and trusted mechanism that adds credibility to a securitization programme'. However, Standard & Poor's admitted that a 'portfolio is clearly open to fraud and crime at many levels'. Moreover, although their analysis takes into account that a pool may contain proceeds of crime, Standard & Poor's admitted again that 'we don't have the ability to detect the fraud/crime being experienced but the originator/servicer does'. Thus, the onus is on the originator to detect any fraud or crime that may allow it to mingle dirty money with clean money. The rating agency relies largely on what the originator informs it with regards to any risks associated with fraud, and the rating agency uses what the originator informs it in its testing scenarios.

Moreover, Weiss Rating responded – 'the only way a credit rating agency can detect fraudulent receivables is by analyzing each of the underlying assets in the pool'. They also added that 'receivables in a securitization program will not be individually examined'. The rating agency examines only the quality of the pool and does not go further to inquire whether they could be proceeds of crime. This is certainly a shortfall of the rating criteria which the author has exposed – Standard & Poor's are now conducting research into this area.

vi. A major part of the accountant's task is to undertake a "collateral audit" which is a sieve like audit that weeds out any non-performing or defaulting receivables from the pool. This collateral audit involves analysing the pool's contents for changes in performance and levels of liquidity. The frequency of this audit depends largely on the term and payment pattern of the receivables. The collateral audit only seeks to weed out non-performing and defaulting receivables – it is not designed to weed out proceeds of crime or other suspicious looking receivables. Any suspicious looking receivables are weeded out because they are non-performing or defaulting, and not because they may be proceeds of crime. Interestingly, receivables which are in fact proceeds of crime are more likely to materialise and generate the income evidenced by manufactured paperwork. The launderer will want to place the proceeds of crime into the financial system. Thus, does the collateral audit fail to detect proceeds of crime? It seems it does – 'a collateral audit which is also referred to as a pool audit is simply a periodic process that helps the pool maintain its financial strength. It is, as you say, not designed to catch illegitimate receivables…and I agree with you when you say illegitimate receivables are more likely to materialise into cashflow than legitimate receivables'.

Aside from the collateral audit there is no other analysis undertaken by the accountant. Another task undertaken by the accountant is to document the pool's behaviour in annual accounts – how much income was received and how much of this was paid out to investors.

vii. The conclusion of this empirical research depicts justification for the author's theory that securitisation can be used and abused to launder proceeds of crime. The originator who isolates the receivables can easily be tempted to include proceeds of crime into the pool because paperwork can be manufactured. The professionals who analyse the pool for quality and strength admit the impracticality of analysing each receivable, and moreover, their duties are confined and are executed within a small window of time. The intangible nature of a pool makes it difficult to verify the true source of each receivable. The two worrying effects of this conclusion are, firstly, given that the securitisation market has been in existence for more than two decades, how many of the hundreds of transactions have been merely used to launder proceeds of crime? Secondly, given the nature of this vulnerability, what mechanism can be introduced to limit or prevent the damaging effect of using securitisation to launder proceeds of crime?

In the author's view, the transaction would need to be amended to include separate recourse provisions against the originator in the event that the pool is later found to contain proceeds of crime. However, this solution may not be workable at present given the current standpoint on "true sale" where the originator must relinquish all risks associated with the pool and any recourse must be accounted for in the originator's balance sheet. Including separate recourse provisions to cover the risk that a pool may contain proceeds of crime (which if, at a later date, freezes the pool) will certainly alter how "true sale" is currently defined and can potentially recharacterise the transaction as a secured lending. These concluding effects were also discussed with Standard & Poor's, who agreed with the author's theory and have now commenced new research analysing this vulnerability.

6. Securitisation and White Collar Crime

The author, using established theories on white collar crime, concluded his reasons why an originator and other professionals would use and abuse securitisation to launder proceeds of crime as follows:

i. Because it is easy to use and abuse. The complexity of securitisation and the credibility and reputation of the securitisation market all help to mask an important vulnerability which an originator can potentially abuse. There is a very low risk of detection, as the author demonstrated in chapter four. If investors lose out then blame lies with the underlying obligors and the professionals who composed the securitisation. Thus, which criminal would not want to abuse a process that has such vulnerabilities?

ii. Sutherland theorised that criminality is learnt through association with criminals and this association will dictate the development of criminal characteristics. Sutherland also believed that unless an alternative and conflicting behaviour was introduced to the individual, the individual is more likely to develop criminal characteristics which would ultimately lead to participating in white collar crime. The author accepts this theory to the extent that criminality is more likely to be learnt through association but disagrees with Sutherland's point that an alternative and conflicting behaviour can prevent criminality. Money laundering is a crime that has grown regardless of what rules have been introduced. Launderers cleverly work around the rules. Thus, if such rules are seen as the alternative and conflicting behaviour then it seems that the growing concern relating to, and the reported facts about money laundering refute Sutherland's point.

iii. Professor Stotland theorised that the criminal commits the crime because there is a desire for money and superiority, and a threat of loss. This helps to explain why a launderer participates in the laundering process. The launderer wants to keep the proceeds of crime that have been generated through illegal activity – this is the desire for money and the threat of loss. The justification for keeping the proceeds of crime is the high risk the launderer is taking when generating and cleaning such proceeds. Stotland also adds that the criminal undertakes the white collar crime in order to achieve a sense of superiority – this, it seems, again refutes Sutherland's point on the alternative and conflicting behaviour preventing criminality. The launderer would still launder the proceeds even though there are rules in place, and in part would do so to achieve a sense of superiority – he/she has cleverly worked around the rules and evaded detection.

iv. The author believes that organisations which desire to commit white collar crime will do so in an environment which it has developed itself – organisations will recruit individuals who can be easily moulded to work in its culture and environment. This was researched by Professors Duffield and Grabowsky who conclude that a corporate is likely to recruit an individual who can be moulded into the employee the employer wants. The author highlighted the case of Robin Greenburg. Once conforming individuals are recruited they are then exposed to the culture of competition which is 'characterised by an intense desire for wealth and success and an overwhelming fear of failure' to the extent that 'occupational positions virtually force their occupants to violate the law in order to succeed'. Weisburd goes further to say that where criminality becomes part of the workload then 'white collar criminals do not view their actions as criminal and themselves as criminals and that the reasons for committing the crime were to further the interests of the company'. But Weisburd's theory is limited to the employee knowing that it is doing wrong and consequently denying the criminality of the action, but nevertheless, demonstrates the extent to which employees would push themselves within the culture of competition. This in turn triggers the "rationalisation" theory which, it seems, would apply to the criminal behaviour of the originator who uses securitisation to launder proceeds of crime. Regardless of the rules in place and the various deterrents, the criminal originator is still motivated to launder the proceeds of crime because it "neutralises" the guilt and awareness of its actions before committing the crime by believing that it is not committing an offence. Thus, in the author's view, the structure and culture are important contributing characteristics which dictate the level, if any, of white collar crime committed by the organisation and its employees.

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